No. 91-1421-CFX
Status: GRANTED

Title: United States, Petitioner,
v.
William F. Hill, et ux.

Docketed:
March 6, 1992

Court: United States Court of Appeals for the Federal Circuit

Counsel for petitioner: Solicitor General, Solicitor General

Counsel for respondent: Robinson,Richard B

Time to file ext by Chief Justice to & inc March 7, 1992 CITED

Entry	Date	Note	Proceedings and Orders
1	Jan 27 1992	G	Application (A91-536) to extend the time to file a petition for a writ of certiorari from February 6, 1992 to March 7, 1992, submitted to The Chief Justice.
2	Jan 27 1992		Application (A91-536) granted by the Chief Justice extending the time to file until March 7, 1992.
3	Jan 27 1992		Application for extension of time to file petition and order granting same until March 7, 1992 (Rehnquist, February 27, 1992).
4	Mar 6 1992	G	Petition for writ of certiorari filed.
5	Apr 8 1992		DISTRIBUTED. April 24, 1992
6	Apr 10 1992	X	Brief of respondents William Hill, et ux. in opposition filed.
8	Apr 21 1992	X	Reply brief of petitioner United States filed.
7	Apr 27 1992		Petition GRANTED.
			**
10	Jun 8 1992		Order extending time to file brief of petitioner on the merits until July 2, 1992.
11	Jun 11 1992		Joint appendix filed.
12	Jul 1 1992		Brief of petitioner United States filed.
13	Jul 23 1992		Record filed.
		*	Original proceedings United States Claims Court.
14	Jul 31 1992		Brief amici curiae of National Coal Association, et al. filed.
15	Jul 31 1992		Brief of respondent William Hill, et ux. filed.
16	Aug 11 1992		CIRCULATED.
17	Aug 11 1992		Record filed.
		*	Partial proceedings United States Court of Appeals for the Federal Circuit.
18	Aug 21 1992		SET FOR ARGUMENT MONDAY, NOVEMBER 2, 1992. (1ST CASE).
19	Sep 2 1992	X	Reply brief of petitioner filed.
20	Oct 28 1992	X	Supplemental brief of petitioner filed.
21	Nov 2 1992		ARGUED.

91-1421

No.

In the Supreme Court of the United States

October Term, 1991

United States of America, petitioner

v.

William F. Hill and Lola E. Hill

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

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QUESTION PRESENTED

Whether the unrecovered cost of depreciable improvements to a mineral deposit may properly be included in the adjusted basis of that property in determining the amount of the deduction for depletion that constitutes a tax preference item subject to the minimum tax under Section 57(a)(8) of the Internal Revenue Code, 26 U.S.C. 57(a)(8) (1976).

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In the Supreme Court of the United States

OCTOBER TERM, 1991

No.

UNITED STATES OF AMERICA, PETITIONER

v.

WILLIAM F. HILL AND LOLA E. HILL

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Federal Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a) is reported at 945 F.2d 1529.[1] The opinion of the Claims Court (App., *infra*, 2a-23a) is reported at 21 Cl. Ct. 713.

JURISDICTION

The judgment of the court of appeals (App., *infra*, 28a) was entered on September 11, 1991. The court of appeals denied the petition for rehearing on No-

[1] The court of appeals adopted the opinion of the Claims Court (App., *infra*, 2a-23a).

vember 8, 1991 (App., *infra*, 29a) and declined the suggestion for rehearing *en banc* on December 19, 1991 (App., *infra*, 30a). On January 27, 1992, the Chief Justice extended the time for filing the petition for a writ of certiorari to March 7, 1992. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTE INVOLVED

Section 57 of the Internal Revenue Code, 26 U.S.C. 57 (1976),[2] provides in relevant part:

> (a) *In General.*—For purposes of this part, the items of tax preference are—
>
> * * * * *
>
> (8) *Depletion.*—With respect to each property (as defined in section 614), the excess of the deduction for depletion allowable under section 611 for the taxable year over the adjusted basis of the property at the end of the taxable year (determined without regard to the depletion deduction for the taxable year).
>
> * * * * *

STATEMENT

1. During 1981 and 1982, respondents were engaged in the business of oil and gas exploration, development and production. This case concerns the

[2] Subsection 57(a)(8) was redesignated as Subsection 57(a)(1) for taxable years beginning after 1986. This change occurred as part of a revision of Section 57 in the course of enacting the Internal Revenue Code of 1986. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 701(a) and (f)(1), 100 Stat. 2085. Unless otherwise specifically stated, citations in this petition shall be to the Internal Revenue Code as it existed in 1981 and 1982, the years at issue in this case.

proper calculation of the "tax preference" income that they received in those years from the percentage depletion deductions they took under Section 613 of the Internal Revenue Code, 26 U.S.C. 613 (1982).

a. Section 611 of the Code allows taxpayers with an economic interest in oil and gas or other mineral deposits to deduct from their gross income both a reasonable allowance for the depletion of the mineral deposit and a reasonable allowance for depreciation of the tangible improvements to the property (*e.g.*, machinery, pipes and similar items). The allowance for depreciation of "tangible" improvements is based upon the taxpayers' *costs* of acquiring the improvements; once taxpayers have fully recovered these costs through annual depreciation, no additional deductions are allowed. See 26 U.S.C. 167(c), 1016(a)(2). By contrast, the percentage depletion allowance is based upon the taxpayers' *revenues* from production of the mineral deposit; this allowance continues so long as revenues are received, even if the costs of acquiring and developing the mineral deposit have been fully recovered. 26 U.S.C. 613.

By permitting deductions that may be far in excess of the actual investment made to obtain and develop the mineral deposit, the percentage depletion allowance provides an unusual tax advantage to mineral producers. See *United States* v. *Swank*, 451 U.S. 571, 576-577 (1981). In 1969, concerned that high income taxpayers were succeeding in reducing, if not eliminating, their federal income tax liability through extensive use of allowances such as percentage depletion, Congress enacted a minimum tax on "tax preference" income. Congress classified the deduction for percentage depletion as a "tax preference" (26 U.S.C. 57(a)(8) (1976)) and subjected the income

sheltered by the deduction to the minimum tax. During the years involved in this case, the minimum tax was 15% of the amount by which such "tax preference" income exceeded the specific deductions permitted under Section 56 of the Code. See 26 U.S.C. 56 (1976).[3]

The calculation of the taxpayer's "tax preference" income is the first step in determining this minimum tax. Under Section 57(a)(8), "tax preference" income includes the excess of the percentage depletion deduction in any year "over the adjusted basis of the property" for that year. 26 U.S.C. 57(a)(8) (1976). The statute expressly provides (*ibid.*) that the term "property" in Section 57(a)(8) is to be given the same meaning afforded that term in Section 614 of the Code, 26 U.S.C. 614 (1976). In turn, Section 614 defines the term "property" as the taxpayer's interest in any specific "mineral deposit." *Ibid.*[4]

Under Section 57, percentage depletion deductions are thus treated as "tax preference" items only *after* the taxpayers have fully recovered their cost basis in the "mineral deposit." It is only when deductions are permitted in excess of this cost basis that the ordinary economic principles embedded in the Code

[3] Under Section 55 of the current provisions of the Code, items of "tax preference" are now included in the calculation of the "alternative minimum tax." 26 U.S.C. 55. This tax is assessed on tax preference income at the rate of 20% for corporations and 24% for other taxpayers. 26 U.S.C. 55(b)(1) (to be codified).

[4] 26 U.S.C. 614(a) (1976) provides:

> For the purpose of computing the depletion allowance in the case of mines, wells, and other natural deposits, the term "property" means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land.

(that limit deductions from income to the amount necessary to recover the costs of producing that income) are violated. Percentage depletion deductions taken *before* the taxpayers have fully recovered their investment in the mineral deposit are therefore not treated as tax preference items under the Code. 26 U.S.C. 57(a)(8) (1976).

b. Respondents asserted in the tax returns that they filed for 1981 and 1982 that, in calculating their "tax preference" income, the percentage depletion allowance for each year should be reduced not only by the unrecovered costs of the depletable mineral deposit (*i.e.*, the cost of acquiring ownership of the mineral deposit plus the intangible costs of drilling the well)[5] but also by the unrecovered cost of the depreciable "tangible" improvements to the mineral deposit (such as pipes, tools and other equipment having salvage value). Since respondents claimed \$206,545 and \$131,216 in unrecovered "tangible" costs in 1981 and 1982 respectively (App., *infra*, 25a), the addition of these costs to the adjusted basis of the depletable mineral deposit substantially reduced respondents' "tax preference" income (App., *infra*, 6a).

The Internal Revenue Service (IRS) concluded that tangible improvements are not part of the "mineral deposit" under Section 57 and that the unrecovered costs of such improvements are therefore not to be considered in calculating respondents' preference in-

[5] Intangible drilling costs may either be deducted in the year incurred or added to the basis of the depletable mineral deposit. See 26 C.F.R. 1.612-4(a), (b)(1) and (b)(2). As ordinarily occurs, the taxpayers elected in this case to deduct their intangible costs fully when incurred (App., *infra*, 5a). The intangible drilling costs therefore play no role in the "tax preference" calculations in this case.

come (App., *infra*, 6a-7a). The Service thus determined that respondents owed additional taxes under the minimum tax provisions.[6] Respondents paid the resulting tax deficiencies and filed administrative refund claims. When the IRS failed to grant the requested refunds, respondents filed this suit in the Claims Court.

2. On cross motions for summary judgment, the Claims Court held that respondents were entitled to include the unrecovered costs of depreciable tangible improvements in the adjusted basis of their depletable mineral deposits in calculating the amount of depletion that constitutes an item of tax preference subject to the minimum tax (App., *infra*, 2a-23a). The court acknowledged that "the Code establishes separate rules" for depreciable and depletable property and that "the costs of depreciable improvements to the property are not a factor when calculating the amount of the depletion deduction" (App., *infra*, 9a-10a). The court therefore "admitted[]" (*id.* at 102) that comparing the depletion deduction only to *depletable* costs (rather than also to *depreciable* costs) "would create a symmetry of sorts because the unrecovered tangible costs are not a factor when calculating the depletion deduction in the first place" (*ibid.*). While the court recognized (*ibid.*) that "Congress clearly could have decided * * * that unrecovered tangible costs not be a part of the equation" in calculating the tax preference, the court stated that Congress also *could* have chosen to reduce the amount of such tax preference income by deducting unrecovered depreciable costs in order to advance the "aim of encouraging development of oil and gas revenues" (*ibid.*).

Finding no "clear indication" in the text or history of the statute to guide its decision (App., *infra*, 11a & 15a-17a, n.10), the court relied on what it perceived to be the general principle that the word "property"—even as applied to a "mineral deposit"—necessarily encompasses "improvements" to the property (App., *infra*, 11a-23a). The court therefore held that Section 57(a)(8) requires inclusion of unrecovered, depreciable tangible costs in the basis of the "mineral deposit" in calculating tax preference income.

3. The court of appeals affirmed and adopted the opinion of the Claims Court (App., *infra*, 1a). In dissent, Chief Judge Nies observed that the term "property" incorporated by Section 57 from Section 614 refers specifically to the "*mineral deposit*" (App. *infra*, 24a) and that the Claims Court opinion neglected to consider the long-standing distinction between the term "mineral deposit" and the term "mineral enterprise" (App., *infra*, 25a-26a, citing 26 C.F.R. 1.611-1(d)(3)). The term "mineral enterprise" has long been defined by regulations as the

[6] The parties' computations may be summarized as follows:

	Respondents 1981	Respondents 1982	Government 1981	Government 1982
Depletion allowable	$439,884	$371,636	$439,884	$371,636
Less: Unrecovered intangible costs (expensed)	-0-	-0-	-0-	-0-
Less: Unrecovered tangible costs	206,545	131,216	Disallowed	Disallowed
Depletion constituting a tax preference item	$233,339	$240,420	$439,884	$371,636

The tax deficiencies resulting from the government's calculations were $30,963 for 1981 and $18,733 for 1982 (App., *infra*, 2a).

"mineral deposit" *plus* "improvements" (*ibid.*). The distinction that is drawn between "mineral deposit" and "mineral enterprise" is important because "only the mineral deposit itself is subject to a depletion allowance" (App., *infra*, 26a). The Chief Judge noted (*ibid.*, citing 26 C.F.R. 1.611-2(b)(1)):

> The capital account of the mineral deposit on which depletion is calculated includes the cost of the deposit itself and certain * * * specific adjustments. It does not include the cost of improvements * * *.

Under the majority's holding, however, tangible costs that are not part of the basis of the "mineral deposit" (but instead form part of the basis of the "mineral enterprise") "may be transferred over to the mineral deposit so as to reduce the minimum tax" (App., *infra*, 26a). Chief Judge Nies concluded that "a straight forward as well as logical reading of the statute" compels rejection of the claim that Congress intended to include the costs of depreciable improvements in the basis of the taxpayers' depletable "mineral deposit" (App., *infra*, 26a-27a):

> Inasmuch as only the deposits themselves are the "property" depletable under Section 611, it is solely the adjusted basis of that "property" which must be deducted from the depletion allowance to arrive at the excess of depletion subject to the minimum tax.

REASONS FOR GRANTING THE PETITION

The decision in this case misapplies the text and history of Section 57 of the Internal Revenue Code to reach an illogical conclusion with dramatic fiscal consequences. The Federal Circuit's decision was issued by a court with nationwide jurisdiction. Since all taxpayers with tax preference income are entitled to pay the tax and sue for a refund in the Federal Circuit, and since such taxpayers tend to be professionally counseled, it is unlikely that other courts of appeals will have an opportunity to review this same issue. In similar circumstances, this Court has recognized the need for plenary review of Federal Circuit decisions that have great fiscal importance. See, *e.g.*, *United States* v. *Goodyear Tire & Rubber Co.*, 493 U.S. 132, 138 (1989); *United States* v. *American Bar Endowment*, 477 U.S. 105, 109 (1986). Such review is appropriate in this case.

1. The decision of the court of appeals misapplies the definition of "property" incorporated by Section 57(a)(8) from Section 614. The term "property" refers to the taxpayers' interest in a "mineral deposit." 26 U.S.C. 614 (1976). The term "mineral deposit" does not include tangible improvements. To the contrary, the regulations in effect when Congress first enacted Section 57(a)(8) had long distinguished between a "mineral deposit" and a "mineral enterprise," which consists of the "mineral deposit or deposits and improvements" (App., *infra*, 25a-26a, quoting 26 C.F.R. 1-611-1(d)(3)).

By failing to observe the distinction drawn in the statute and the regulations between "mineral enterprise" and "mineral deposit," the court of appeals reached the illogical result that the unrecovered depreciable costs of tangible "improvements" should be

set off against the depletion allowance in calculating tax preference income under Section 57(a)(8). This result is illogical for two reasons. First, it is inappropriate to conclude that costs ultimately to be recovered by *depreciation* may be set off against the depletion allowance for the purpose of determining whether an "excess" recovery of *depletable* costs has occurred (26 U.S.C. 57(a)(8) (1976))—such a conclusion would require the assumption that Congress meant to compare apples (depletion allowance) with oranges (depreciable property) in calculating the amount of the "tax preference." As Chief Judge Nies stated in dissent, there is "no reason, in logic or in the statute and regulations" why Congress would have designed such a strange and self-defeating scheme (App., *infra*, 26a).

Second, the incongruity of the court's interpretation of the statute is emphasized by the fact that, under the court's view, the taxpayer would be allowed to set off the unrecovered balance of depreciable costs *each year*, even when (as here) the depletion allowance in the prior years far exceeds the taxpayer's basis both in its depletable *and* depreciable property (see note 6, *supra*). The purpose of the minimum tax is to capture and tax, even if at a reduced rate, the special deductions that exceed the taxpayer's cost basis in assets that receive preferential treatment under the Code. See 26 U.S.C. 57(a)(1)-(10). That purpose is frustrated and impeded by the decision in this case.

Not only does the language of the statute and regulations provide the "clear indication" of the proper construction of these provisions that the courts below found lacking (App., *infra*, 11a), the legislative history provides equally emphatic guidance. Reduced to its essential core, the multi-billion dollar question presented in this case (see pp. 12-13, *infra*) is whether

the word "property" as used in Section 57(a)(8) refers only to the property that is subject to depletion ("depletable property") or whether it also includes the tangible, depreciable improvements to mineral deposits that are *not* subject to depletion ("depreciable property") (App., *infra*, 25a-26a). As the court of appeals recognized (App., *infra*, 15a-17a, n.10), the legislative history of the original enactment of Section 57 describes the costs to be included in the basis of the "property" as (i) the costs of acquiring the mineral deposits and (ii) the intangible drilling costs that are also subject to the percentage depletion allowance. See S. Rep. No. 552, 91st Cong., 1st Sess. 114, 115 (1969); note 5, *supra*. This history reflects that the "property" referred to in this statute is the *depletable* property and does not include depreciable improvements that are not subject to percentage depletion.

This evident congressional intent was reemphasized by Congress in 1986 when, in the course of revising and reenacting the Code, Congress revised Section 57 and redesignated subsection 57(a)(8) as 57(a)(1). See note 2, *supra*. The Conference Committee Report on the 1986 Act stated in clear and simple terms how the "tax preference" calculation is to be made for the percentage depletion allowance (H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. Pt. 2, at 254 (1986) (emphasis added)):

> The excess over the adjusted basis of the *depletable property* is a preference.

The court of appeals, however, reached the diametrically opposite conclusion that the basis of both depletable *and* depreciable property is to be considered in determining tax preference income. The court's decision is thus at odds with the clear and direct con-

gressional descriptions of the proper interpretation of the statute.[7]

2. The fiscal consequences of the decision in this case are enormous. The Internal Revenue Service advises that, for the period from 1985 to 1989 alone, more than $5 billion of revenue from the minimum tax on tax preference income is affected by this decision.[8] The startling economic effect of this decision was evidently not anticipated by the tax bar (see note 7, *supra*); since the date of the decision, the IRS has received a steady stream of new refund claims (already aggregating in excess of $400,000,000) that seek to benefit from the surprising Federal Circuit ruling.

The reason this decision has such extraordinary fiscal consequences is that it allows unrecovered depreciable costs to be set off against depletion allowances even after such depletion has fully recovered the costs of investment not only in the "mineral deposit" but in the "mineral enterprise" as well. See page 10, *supra*. The fiscal effect of this decision may be even greater than the Service predicts if the court's analysis is applied not only to the oil and gas and

[7] Scholarly critiques of the Federal Circuit decision have also expressed strong disagreement with its conclusions. See Dzienkowski & Peroni, *A Critical Review of the Hill Decisions: Calculating Excess Depletion Under The Alternative Minimum Tax*, 28 Nat. Res. Tax Rev. 243 (Sept.-Oct. 1991); M. McMahon, Jr., *Significant Current Developments in Oil and Gas Taxation*, 42nd Annual Institute on Oil & Gas & Taxation, S.W. Legal Foundation § 15.10[2], at 15-53 (1991) ("The court's analysis is alluring, but incorrect.").

[8] Moreover, since tax returns involving income from mineral deposits are often kept open many years while audits and adjustments are under consideration, the retrospective consequences of the decision could reach back a decade or more.

hard mineral industries under Section 57 but also to the coal and iron ore industries under the parallel language of Section 291(a)(2)(B).[9] Depreciable improvements represent an even greater portion of the taxpayer's total investment in the "mineral enterprise" for coal and iron ore mining than they do for oil and gas exploration, thus producing an even greater effect in reducing the tax that Congress sought to impose on this preference income.

Thus, while we can safely predict that more than a billion dollars of minimum tax revenues will be lost for each tax year to which this decision applies, it is not possible to place a definite upper limit on the ultimate revenue effect of the court's holding. The revenue losses clearly will be enormous. Moreover, these revenue losses will occur in the precise economic arena that Congress specifically determined was benefiting too greatly from improper preferences under the Internal Revenue Code.

Absent review by this Court, the decision of the court of appeals will significantly frustrate the plain

[9] Special rules apply to calculation of the depletion allowance for the iron ore and coal mining industries. Section 291 reduces by 20% the depletion allowance available for these industries when the allowance, as computed under Section 613, exceeds the adjusted basis of the "property." 26 U.S.C. 291(a)(2)(B). If the analysis of the word "property" applied by the court of appeals in its decision in this case were applied also to Section 291, a substantial increase in the depletion allowance available to the iron ore and coal mining industries would result. In addition, under the court's interpretation of Section 57(a)(8), the tax preference income attributable to excess depletion allowances for the iron ore and coal mining industries would be substantially reduced, just as it would be for all other mining industries that receive depletion allowances under Section 613.

intent of Congress to limit the economic abuses of tax preference income. Moreover, by entrenching the unfairness that Congress sought to curtail, the decision in this case affects all taxpayers. It enhances the perceived unfairness of the Code that Congress sought to remedy. The inherent result of the decision in this case is to shift the proportion of the total tax burden imposed by the Code away from the few taxpayers who enjoy preference income and onto those who enjoy no preference.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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MARCH 1992

APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

91-5032

WILLIAM F. HILL AND LOLA E. HILL,
PLAINTIFFS-APPELLEES

v.

THE UNITED STATES, DEFENDANT-APPELLANT

DECIDED: September 11, 1991

Before NIES, *Chief Judge*, BENNETT, *Senior Circuit Judge*, and LOURIE, *Circuit Judge*.

BENNETT, *Senior Circuit Judge*.

OPINION

The Government appeals the United States Claims Court's judgment granting summary judgment for the taxpayers. 21 Cl. Ct. 713 (1990). The court held that for tax years 1981 and 1982, the taxpayers were entitled to include unrecovered tangible improvements in the computation of the adjusted basis of their oil and gas properties under Internal Revenue Code § 57(a)(8) for the purpose of calculating the amount of depletion which is a tax preference item subject to an alternate minimum tax. We affirm on the basis of the court's opinion which we adopt.

AFFIRMED

APPENDIX B

IN THE UNITED STATES CLAIMS COURT

No. 679-88T

(Filed: October 31, 1990)

WILLIAM F. AND LOLA E. HILL, PLAINTIFFS

v.

THE UNITED STATES, DEFENDANT

Tax; claim for refund; deduction; minimum tax; calculation under Section 57(a)(8) of depletion as an item of tax preference; determination of adjusted basis of oil and gas property for calculation of minimum tax; double deductions.

Richard B. Robinson, Denver, Colorado, for plaintiffs. *Robert A. Wherry, Jr.*, of counsel.

Jay G. Philpott, Jr., *Mildred L. Seidman*, and *Gerald B. Leedom*, with whom was *Assistant Attorney General Shirley D. Peterson*, Washington, D.C., for defendant.

OPINION

ANDEWELT, Judge.

In this tax action, plaintiffs, William F. and Lola E. Hill, seek tax refunds for tax years 1981 and 1982 of $30,963 and $18,733, respectively. This action is presently before the court on cross-motions for summary judgment. The dispute relates to the amount of taxes plaintiffs were required to pay under the alternative minimum tax provisions set forth in Sections 56 and 57 of the Internal Revenue Code (the Code), 26 U.S.C. §§ 56 and 57.[1] The parties agree that there are no material issues of fact in dispute and that this case turns on a legal issue—the proper interpretation of the pertinent statutes and regulations. For the reasons set forth below, plaintiffs' proposed interpretation is correct and plaintiffs' motion for summary judgment is granted.

I.

During tax years 1981 and 1982, plaintiffs were engaged in the business of oil and gas exploration, development, and production. Pursuant to Section 611 of the Code, when calculating income tax due, an owner of oil and gas deposits is entitled to deduct from his or her income both a reasonable allowance to cover depletion and a reasonable allowance to cover depreciation of improvements.[2] The Code requires a taxpayer to calculate the depletion deduction in two ways—based on cost depletion pursuant to Section 612 and based on a fixed percentage of the income derived from the property pursuant to Section 613—

[1] For years after December 31, 1982, the alternative minimum tax applicable to individuals is set forth in Sections 55 and 57 of the Code. The references herein to the Code and related Treasury Regulations are to those that applied during the tax years in issue.

[2] Section 611 provides, in pertinent part:

> a) General Rule.—In the case of . . . oil and gas wells . . . there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements . . .; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary.

and then to use the higher amount as the Section 611 depletion deduction. Treas. Reg. 1.611-1(a)(1).

Under Section 57 of the Code, the deduction taken for depletion is classified as an "item of tax preference," which is subject to an alternative minimum tax set forth in Section 56. Section 56 imposes a minimum tax on listed "items of tax preference" [3] and Section 57 lists "Depletion" as an item of tax preference. Under Section 57(a), the amount of the depletion deduction that constitutes an item of tax preference is calculated as follows:

> (8) Depletion.—With respect to each property (as defined in section 614), the excess of the deduction for depletion allowable under section 611 for the taxable year over the adjusted basis of the property at the end of the taxable year (determined without regard to the depletion deduction for the taxable year).

The dispute herein relates to the calculation of the amount of the item of tax preference under Section 57(a)(8). The parties agree that when calculating the depletion allowable under Section 611, plaintiffs properly used Section 613 percentage depletion, and that for tax years 1981 and 1982, plaintiffs were entitled to depletion deductions of $439,884 and $371,636, respectively. The parties disagree, however, as to how to calculate the "adjusted basis of the property" which, pursuant to Section 57(a)(8), is subtracted from the depletion deduction to determine the amount of the item of tax preference.

[3] For tax years 1981 and 1982, Section 56 imposed a 15% tax rate on the excess of the sum of the items of tax preference listed in Section 57 over the deductions allowed in Section 56.

II.

Operators of oil wells incur a variety of drilling and development costs that can be broken down into two categories. The first category is intangible costs and includes "all expenditures made by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas." Treas. Reg. 1.612-4(a). The second category, labeled in the briefs as "tangible costs," involves physical improvements to the property for the operation of the well, *e.g.*, the addition of machinery, tools, equipment, pipes, and similar items "ordinarily considered as having a salvage value." Treas. Reg. 1.612-4(c)(1).

For intangible costs, a taxpayer has the option of either expensing the costs (deducting them totally from his or her income in the year they are incurred) or charging the costs to capital. Treas. Reg. 1.612-4(a).[4] When the intangible costs are charged to capital, depending on the nature of the costs, a taxpayer recovers the costs either through yearly depletion or depreciation deductions. Intangible costs "represented by physical property" (*i.e.*, the costs of installing physical structures) are returnable through depreciation. Treas Reg. 1.612-4(b)(2). Intangible costs "not represented by physical property" are returnable

[4] The general rule in Section 263 of the Code is that a taxpayer cannot expense "[a]ny amount paid out for . . . permanent improvements or betterments made to increase the value of any property." Subparagraph (c), however, carves out a partial exception for "[i]ntangible drilling and development costs in the case of oil and gas wells." The Treasury Secretary is charged with issuing appropriate regulations to implement subparagraph (c), and Treas. Reg. 1.612-4 is the result.

through depletion. Treas. Reg. 1.612-4(b)(1). Examples of intangible costs not represented by physical property are "expenditures for clearing ground, draining, road making, surveying, geological work, excavation, grading, and the drilling, shooting, and cleaning of wells." *Id.*

For tangible costs, a taxpayer does not have the option to expense the costs, but instead must recover the costs over a period of years. Treas. Reg. 1.612-4(c)(1). In addition, rather than being recovered through a combination of depreciation and depletion deductions, tangible costs are recovered only through depreciation deductions. *Id.*

The parties agree that when calculating the "adjusted basis of the property" under Section 57(a)(8), a taxpayer must add to his or her basis those intangible costs not yet recovered that were properly added to capital and were recoverable through depletion. Since the "adjusted basis of the property" is subtracted from the depletion deduction to determine the amount of the tax preference, the amount of the depletion deduction that would constitute a tax preference item and hence be subject to a minimum tax would decrease as the amount of such unrecovered depletable intangible costs increases. The dispute herein involves the treatment under Section 57(a)(8) of unrecovered *tangible* costs, *i.e.*, tangible costs not yet recovered through *depreciation* deductions. Plaintiffs contend that when calculating the "adjusted basis," the unrecovered *tangible* costs should be treated in the same way as the unrecovered depletable *intangibile* costs, *i.e.*, the basis of the property should be adjusted upward to account for the unrecovered costs. Defendant disagrees and contends that unrecovered *tangible* costs do not constitute an adjustment factor when determining the "adjusted basis of the property" under Section 57(a)(8).

III.

Plaintiffs' argument that unrecovered tangible costs are a proper adjustment factor when calculating the "adjusted basis" would give the term "adjusted basis" its ordinary meaning as defined in Sections 1011 through 1016 of the Code. Treas. Reg. 1.57-1(h), which implements Section 57(a)(8), refers taxpayers to Section 1016 for determining the "adjusted basis of the property" for minimum tax purposes. Treas. Reg. 1.57-1(h) provides, in pertinent part: "(3) *Adjusted Basis.* For the determination of the adjusted basis of the property at the end of the taxable year see section 1016 and the regulations thereunder." Section 1016 of the Code, entitled "Adjustments to basis," in turn describes adjustments that should be made to the "basis" of the property.[5] Section 1016 provides, in pertinent part:

> (a) General Rule.—Proper adjustment in respect of the property shall in all cases be made—
>
> (1) for expenditures, receipts, losses, or other items, properly chargeable to capital account.
>
> . . .

Treas. Reg. 1.1016-2, which implements Section 1016, in turn provides that costs of improvements and betterments to property that are not deductible (*i.e.*, not expensed) are expenditures properly chargeable to

[5] Section 1011 of the Code, entitled "Adjusted basis for determining gain or loss," in effect defines the term "adjusted basis" as the Section 1012 basis "adjusted as provided in Section 1016." Under Section 1012, the basis of the property is ordinarily "the cost of such property."

the capital account and, hence, should be considered when calculating the "adjusted basis." Treas. Reg. 1.1016-2 provides, in pertinent part:

> § 1.1016-2. Items properly chargeable to capital account.
>
> (a) The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, *including the cost of improvements and betterments made to the property.* No adjustment shall be made in respect of any item which, under any applicable provision of law or regulation, is treated as an item not properly chargeable to capital account but is allowable as a deduction in computing net or taxable income for the taxable year. For example, in the case of oil and gas wells no adjustment may be made in respect of any intangible drilling and development expense allowable as a deduction in computing net or taxable income.

(Emphasis added.) Defendant acknowledges that the tangible costs here in issue involve improvements and betterments to plaintiffs' oil and gas properties.[6]

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[6] Treas. Reg. 1.611-5(b) treats the tangible goods in issue as "improvements" to an oil and gas property. It provides, in pertinent part:

> (4) In the case of operating oil or gas properties, the deduction for depreciation shall be allowed for those costs of improvements such as machinery, tools, equipment, pipes, and other similar items and the costs of installation which are not treated as a deductible expense under section 263(c).

Hence, relying on this statutory and regulatory scheme, plaintiffs argue that the "adjusted basis of the property" for purposes of Section 57(a)(8) is determined pursuant to Section 1016, and Section 1016 requires an upward adjustment to the basis of the property to account for the costs of unrecovered tangible improvements to the property.

IV.

In response, defendant does not dispute that ordinarily costs associated with tangible improvements to property are added to the basis of the property when calculating the adjusted basis under Section 1016. However, defendant contends that the Code, viewed as an "organic whole" (*see, Lewyt Corp. v. Commissioner*, 349 U.S. 237, 240 (1955); *United States v. Skelly Oil Co.*, 394 U.S. 678, 695 (1969) (Steward, J., dissenting)) demands a different result here. Defendant contends that the Code draws a clear line between depreciation (*see* Section 167) and depletion (*see* Sections 612 and 613) and that adjusting the basis of the property for unrecovered depreciable expenditures when calculating depletion as a tax preference item improperly crosses that line.

Clearly, the Code establishes separate rules for calculating the tax deductions available for depletable and depreciable costs, and the costs of depreciable improvements to the property are not a factor when calculating the amount of the depletion deduction for regular tax purposes under Sections 612 and 613. But the issue herein does not involve the calculation of the amount of the depletion deduction *per se.* Rather, the issue here involves the calculation of the amount of the depletion deduction that constitutes an item of tax preference and hence is subject to a minimum tax.

In drafting the minimum tax provisions, Congress had to make a policy decision as to how much of the depletion deduction should constitute an "item of tax preference" and hence be subject to recapture through the minimum tax. Congress clearly could have decided, as defendant proposes, that unrecovered tangible costs not be a part of the equation and that depletion as a tax preference item be calculated as the excess of the depletion allowance over the cost of the property adjusted exclusively for depletion and unrecovered depletable intangible costs. Admittedly, such an approach would create a symmetry of sorts because the unrecovered tangible costs are not a factor when calculating the depletion deduction in the first place.

On the other hand, it certainly is conceivable that Congress could have decided instead, as plaintiffs propose, that a smaller amount of the depletion deduction potentially be subject to the minimum tax, *i.e.*, that unrecovered tangible costs be included in the adjusted basis and thereby decrease the amount of the tax preference item. The Code provides extensive tax incentives to encourage oil and gas exploration and development. For example, allowing percentage depletion under Section 613 potentially permits a taxpayer depletion deductions that are far in excess of the amount the taxpayer originally paid for the oil and gas deposits. Plaintiffs' proposed interpretation of Section 57 would be consistent with this aim of encouraging development of oil and gas reserves. It would encourage investment in improvements to oil and gas deposits by having the minimum tax not apply to the extent the taxpayer's costs for tangible improvements to the well have not yet been recovered.

The critical focus when resolving which of these policy choices Congress made when it enacted Section 57(a)(8) must be the words of the statute and related regulations. *See United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 242 (1989); *J.H. Miles & Co. v. United States*, 3 Cl. Ct. 10, 13 (1983). In Code Section 57(a)(8) Congress chose to use a technical tax term—"adjusted basis." Section 1016 describes how to calculate the adjusted basis and, as explained above, does not distinguish between treatment of unrecovered tangible costs recoverable through depreciation and unrecovered intangible costs recoverable through depletion. In effect, Section 1016 requires that the basis of property be adjusted upward to account for all unrecovered costs of improvements properly chargeable to the capital account. When interpreting Section 57(a)(8), absent a clear indication in the Code or related regulations to the contrary, the ordinary Section 1016 meaning of the term "adjusted basis" should apply.

V.

Defendant contends, in effect, that the Code and related regulations contain a clear indication to the contrary. Defendant's argument commences with and relies primarily upon the definition of the term "property" in Section 614 of the Code.

Defendant's argument proceeds as follows. Section 57(a)(8) states that the tax preference applicable to depletion is calculated "[w]ith respect to each property (as defined in section 614). . . . " Section 614, in turn, provides: "For the purpose of computing the depletion alowance . . . of . . . wells, . . . the term 'property' means each separate *interest* owned by the taxpayer in each *mineral deposit* in each separate tract or parcel of land." (Emphasis added.)[7] Treas.

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[7] Section 614 provides, in pertinent part:

(a) General rule.—For the purpose of computing the depletion allowance in the case of mines, wells, and other

Reg. 1.614-1(a)(2), which implements Section 614, defines the term "interest" to mean "an economic interest in a mineral deposit" and refers to Treas. Reg. 1.611-1 pargraph (b), which in turn defines "economic interest" so as to require the taxpayer to have made a capital investment in the mineral deposit.[8] Defendant does not dispute that plaintiffs had

natural deposits, the term "property" means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land.

(b) Special rules as to operating mineral interests in oil and gas wells or geothermal deposits.—In the case of oil and gas wells or geothermal deposits—

(1) In general.—Except as otherwise provided in this subsection—

(A) all of the taxpayer's operating mineral interests in a separate tract or parcel of land shall be combined and treated as one property, and

(B) the taxpayer may not combine an operating mineral interest in one tract or parcel of land with an operating mineral interest in another tract or parcel of land.

(2) Election to treat operating mineral interests as separate properties.—If the taxpayer has more than one operating mineral interest in a single tract or parcel of land, he may elect to treat one or more of such operating mineral interests as separate properties. The taxpayer may not have more than one combination of operating mineral interests in a single tract or parcel of land.

[8] § 1.611-1 Allowance of deduction for depletion.

* * * * *

(b) *Economic Interest.* (1) Annual depletion deductions are allowed only to the owner of an economic interest is possessed in every case in which the taxpayer has . . . in mineral deposition standing timber. An economic interest . . . acquired by investment any interest in mineral in place or standing timber and secures, by any

the required economic interest. Defendant focuses, however, on Treas. Reg. 1.611-1 paragraph (d), which defines the terms (1) "property" to mean each separate interest owned in each "mineral deposit," (2) "mineral deposit" to refer only to the "minerals in place," and (3) "mineral enterprise" to include mineral deposits, improvements, and portions of the surface of the land.[9] Defendant contends that because

form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. . . . A person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation. he possesses a mere economic or pecuniary advantage derived from production.

[9] Treas. Reg. 1.611-1(d) provides, in pertinent part:

(d) Definitions. As used in this part and the regulations thereunder the term:

(1) "Property" means—(i) in the case of minerals, each separate economic interest owned in each mineral deposit in each separate tract or parcel of land or an aggregation or combination of such mineral interests permitted under section 614(b), (c), (d), or (e) . . . .

* * * * *

(3) "Mineral enterprise" is the mineral deposit or deposits and improvements, if any, used in mining or in the production of oil and gas, and only so much of the surface of the land as is necessary for purposes of mineral extraction. The value of the mineral enterprise is the combined value of its component parts.

(4) "Mineral deposit" refers to minerals in place. When a mineral enterprise is acquired as a unit, the cost of any interest in the mineral deposit or deposits is that proportion of the total cost of the mineral enterprise which the value of the interest in the deposit or deposits bears to the value of the entire enterprise at the time of its acquisition.

Treas. Reg. 1.611-1(d)(1) dfines the term "property" as "minerals in place" and does not refer to improvements, Congress, in referencing the Section 614 definition of property in Section 57(a)(8), must have intended that the taxpayer exclude the cost of such improvements when calculating the "adjusted basis" of the property.

But this conclusion does not follow from the wording of the Code and related regulations. Section 614 defines property "[f]or the purpose of computing the depletion allowance" and further establishes the rules for when a taxpayer can aggregate his or her interests in mineral deposits into a single property. By referencing the Section 614 definition of property, Section 57(a)(8) clearly envisions application of the same rules for tax preference purposes and envisions calculating the item of tax preference based on the same "property" for which the depletion deduction was calculated in the first place.

But, while Section 614 defines "property" in terms of interest in "mineral deposits" and speaks expansively about when interests in mineral deposits can be aggregated into a single property, it says nothing about what adjustments to the cost basis of *that property* are appropriate when calculating the "adjusted basis" of the property. Pursuant to Treas Reg. 1.57-1 (h), that subject is covered in Section 1016 which, as described above, enunciates the rule that "in all cases," adjustment "in respect of the property" shall be made "for expenditures . . . properly chargeable to capital account."

Defendant's proposed interpretation of Section 57 (a)(8) blurs the distinction between property and improvements to property. Section 1016 calls for adjusting the basis of the property to account for qualifying unrecovered costs of improvements. There is no

requirement therein that the expenditures and related improvements be the property *per se* in order to have their cost factored in when calculating the "adjusted basis." Stated in another way, it is not material under Section 1016 that the tangible improvements herein are not "mineral deposits" or "minerals in place." An adjustment to the basis under Section 1016 is appropriate so long as the tangible costs involve qualifying improvements to the property, *i.e.*, improvements to the mineral deposits.

Moreover, defendant's contention to the effect that the only item to be considered when calculating the "adjusted basis" is the "minerals in place" is inconsistent with the undisputed way in which the regulations treat intangible costs. As explained above, defendant acknowledges that unrecovered depletable intangible costs "not represented by physical property" are properly added to the basis when calculating the adjusted basis for Section 57(a)(8) purposes. But the subject matter of such unrecovered depletable intangible costs fit no more within the Section 614 definition of "property" than does the subject matter of unrecoverable depreciable tangible costs. More specifically, clearing ground, drilling, shooting, and clearing wells, which involve depletable intangible costs, are no more "mineral deposits" than pumps or pipes, which involve depreciable tangible costs. The definition in Section 614 of "property" is therefore only the starting point in calculating the "adjusted basis of the property." Once the property is defined consistent with Section 614, Treas. Reg. 1.57-1(h) requires that the taxpayer resort to the rules in Section 1016 and related regulations to calculate the "adjusted basis" thereof.[10]

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[10] At oral argument, defendant characterized the legislative history of Sections 56 and 57 as "not all that helpful." The

VI.

Defendant contends that including tangible costs in the adjusted basis would allow plaintiffs a double deduction of those costs from income and that inter-

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court agrees. There are brief statements that arguably benefit each side, but nothing definitive. One statement that arguably aids defendant is a description of depletion as a tax preference item in a Senate Committee Report. S. Rep. No. 91-552, 91st Cong., 1st Sess. 114, 115 (1969-3 Cum. Bull. 423, 497). The Report, issued by the Committee on Finance, comments on a bill (H.R. 13270, 91st Cong., 1st Sess. (1969)) that, after subsequent amendment by a House-Senate Conference Committee, was enacted as Sections 56 and 57. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487. In pertinent part, the Senate version established an item of tax preference for oil and gas properties that was calculated by combining two distinct amounts set forth in subparagraphs (A) and (B), respectively. The first amount, set forth in subparagraph (A), was the total amount of intangible drilling and development costs that were expensed by the taxpayer for the tax year. The description of the second amount, set forth in subparagraph (B), involved the depletion deduction and employed the term "adjusted basis." It provided:

> (B) the excess of the deduction for depletion allowable under section 611 for the taxable year over the amount which the adjusted basis of the property would have been at the end of the taxable year (determined without regard to the depletion deduction for the taxable year) had the basis of the property been increased by amounts attributable to the property and treated as an item of tax preference under subparagraph (A) for any taxable year.

H.R. 13270, 91st Cong., 1st Sess. 230 (1969). The Senate Report describes this proposed two-part tax preference item, in pertinent part, as follows:

> (9) Depletion and intangible drilling and development costs,—This is the sum of two items: the deduction for intangible drilling and development costs . . . and the excess of the depletion deduction taken for the year over *the cost of the property* reduced for depletion taken in prior years. In this case the intangible drilling and development costs, to the extent that they are treated directly as a preference item, are treated as a part of the recoverable cost in determining the depletion preference.

pretations of the Code resulting in double deductions are not favored. *See Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62, 68 (1934); *Missouri & Pacific Corp. v. United States*, 5 Cl. Ct. 296, 302 (1984). Clearly, under plaintiffs' approach, the tangible costs would be considered in two different income tax calculations—first, when calculating the adjusted basis of the oil and gas property under Section 57(a)(8) and, second, when the tangible costs are recovered in a later year through a depreciation deduction. But this would not constitute a double deduction from taxable income

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S. Rep. No. 91-552, 91st Cong., 1st Sess. 114, 115 (1969-3 Cum. Bull. at 497) (emphasis added). This description of the calculation of the adjusted basis in subparagraph (B) would be generally consistent with defendant's interpretation of Section 57(a)(8) if by "cost of the property" the Senate meant the original cost of the mineral deposits. But it is clear that Congress did not so intend from the very next sentence in the Report, which indicates that expensed intangible drilling and development costs are treated as a part of the cost of the property. In addition, the Conference Report, when describing the item of tax preference relating to the depletion deduction, did not repeat the reference to "cost of the property." Rather, in explaining the calculation involved in Section 57(a)(8), it used the term "cost *or other basis* on which the depletion preference is computed." H.R. Conf. Rep. No. 91-782, 91st Cong., 1st Sess. 302 (1969-3 Cum. Bull. 644, 659) (emphasis added). Finally, as explained above, it is undisputed that Congress intended the intangible costs that were capitalized and unrecovered to be part of the adjusted basis. In this context, the reference to "cost of the property" in the Senate Report does not demonstrate any unambiguous congressional intent to exclude costs other than the purchase price of the mineral deposits when calculating the "adjusted basis" of the property.

because consideration of these costs when calculating the adjusted basis of the property does not involve a deduction from income.

Sections 56 and 57 establish a separate (alternative) tax scheme, which, through a minimum tax, effectively recaptures certain deductions allowed under the Code. Each item of tax preference in Section 57 relates to a specific deduction allowable in a separate section of the Code. This minimum tax scheme involves four steps: (1) individual items of tax preference are calculated (*i.e.*, the part of the deduction potentially subject to the minimum tax is calculated); (2) the amounts of the individual items are then added together; (3) specified deductions are allowed from that total;[11] and (4) the minimum tax rate is then applied to the remainder. (Section 56.) Thus, the first step—the calculation of the individual tax preference items—is directed at defining one part of a pool of certain tax deductions allowed under the Code, which after *subsequent* deductions is subject to the minimum tax.

With respect to Section 57(a)(8), the first step can be viewed as a determination of how much of the depletion deduction is potentially subject to the minimum tax or, in the alternative, as a determination of how much of the income originally sheltered from taxation through a depletion deduction will be subject to

[11] Code Section 56(a) allows a taxpayer to deduct from the sum of the items of tax preference the greater of $10,000 or "the regular tax deduction." Section 56(c) defines "the regular tax deduction" as "an amount equal to one-half of . . . the taxes imposed by this Chapter for the taxable year," after specified adjustments (*e.g.*, taxes under certain sections are excluded and the sum is reduced by certain tax credits). Section 56(b) allows a deferral of the minimum tax calculated in certain instances where the taxpayer has a new operating loss.

a tax. *See Mobley v. United States*, 8 Cl. Ct. 767 (1985). But under neither interpretation would the first step's calculation of the adjusted basis and the item of tax preference amount to taking a deduction from otherwise taxable income.

Indeed, defendant's double deduction theory, which treats the inclusion of tangible costs in the Section 57(a)(8) adjusted basis as involving a deduction of those costs from income, is inconsistent with the way defendant acknowledges the Code and regulations operate for other costs. There is no dispute that under the controlling statutes and regulations other costs are included in the adjusted basis (*e.g.*, the unrecovered purchase price of the minerals and the unrecovered depletable intangible costs of improvements). But, these other costs, like the tangible costs, are recoverable through deductions in later years. Therefore, consistency with defendant's double deduction theory would require that these other costs also be excluded from the adjusted basis.[12]

[12] In its briefs, defendant seeks to support its double deduction theory by citing the following statement in the Senate Committee Report (*see* n. 10, *supra*).

> As a general rule, the deductions provided under the regular individual and corporate income taxes will not be allowed for purposes of the minimum tax. This is because once the items have been deducted under the regular income tax, allowing them over again under the minimum tax would provide duplicate tax allowances. The committee's provision makes one exception to this rule with regard to net operating losses.

S. Rep. No. 91-552, 91st Cong., 1st Sess. 116, 117 (1969-3 Cum. Bull. at 423, 498).

But in view of the discussion above, this statement cuts against defendant. As noted, there is no dispute that the unrecovered purchase price of the mineral deposits and the unrecovered intangible depletable costs are included in the adjusted basis under Section 57(a)(8) and therefore are simi-

There is one situation where the Treasury regulations clearly do provide that the cost of depreciable improvements are to be excluded when calculating the "basis" of oil and gas properties. That situation is when a taxpayer calculates his or her depletion deduction by using the Section 612 cost depletion rather than the Section 613 percentage depletion. Treas Reg. 1.612-1 specifically states, however, that the required procedure involves a "special rule"—an exception to the ordinary procedures used for calculating the adjusted basis. It provides, in pertinent part:

> § 1.612-1 Basis for allowance of cost depletion.
>
> (a) *In general.* The basis upon which the deduction for cost depletion under section 611 is to be allowed in respect of any mineral or timber property is the adjusted basis provided in section

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larly subtracted from the depletion deduction in the first step calculation of the minimum tax scheme. If the subtraction of these costs from the amount of the deduction in the first step calculation were viewed as a deduction from income, the Senate would also have listed these costs in addition to the net operating loss as "exceptions" to the "no double deduction" comment.

In any event, this is not a situation where plaintiffs are "allow[ed] . . . over again" a deduction already "deducted under the regular income tax." As noted above, the calculation of the amount of an item of tax preference does not involve any deduction from income. In addition, the tangible costs plaintiffs seek to add to the adjusted basis have never previously been deducted from income—they are being added to the basis precisely because they are unrecovered. When placed in context, it seems clear that in the quoted statement, the Senate was referring to deductions taken during the third step of the minimum tax scheme in which deductions are taken from the sum of the items of tax preference. The Senate was not referring to the first step in which items of tax preference are calculated by subtracting certain amounts from the deductions allowed under the regular income tax.

> 1011 for the purpose of determining gain upon the sale or other disposition of such property except as provided in paragraph (b) of this section. . . .
>
> (b) *Special rules.* (1) The basis for cost depletion of mineral, or timber property does not include:
>
> > (i) Amounts recoverable through depreciation deductions, through deferred expenses, and through deductions other than depletion . . . .

Section 612 and Treas. Reg. 1.612-1 do not help defendant. First, Section 612 is not involved because plaintiffs calculated their depletion allowance using percentage depletion under Section 613, rather than cost depletion under Section 612. Second, as summarized above, while it is clearly appropriate to exclude depreciable costs when calculating the amount of the depletion deduction in the first place, the minimum tax presents a distinct policy issue that reasonably could have been resolved by Congress in a different way. Third, and most significantly, the controlling statutes and regulations contain no equivalent "special rule" for assessing the "adjusted basis" of the property under Section 57(a)(8). To the contrary, Treas. Reg. 1.57-1(h)(3) appears to mandate use of the ordinary Section 1016 procedures by stating: "For the determination of the adjusted basis of the property at the end of the year see section 1016 and the regulations thereunder."

Indeed, rather than aiding defendant's proposed interpretation of Section 57(a)(8), Section 612 would appear to favor plaintiffs' interpretation. By specifying that for Section 612 cost depletion purposes a "special rule" applies under which amounts recover-

able through depreciation are excluded from the "basis" of the property, Treas. Reg. 1.612-1 would appear to acknowledge that absent such a "special rule," the basis of Section 614 property would include such amounts.

VIII.

"Technical Advice Memoranda" (TAM) issued by the Internal Revenue Service (IRS) are not binding on the IRS. However, the approach the IRS took in TAM 8314011, issued on December 22, 1982, is instructive. That memorandum involved a calculation of the depletion item of tax preference under Section 614 property. The taxpayer amended its return to include in the "adjusted basis" of the property certain intangible costs that had been capitalized rather than expensed and had not yet been recovered. The IRS approved this adjustment stating: "The term 'adjusted basis' has the same meaning whether used in section 57(a)(8), section 612, or elsewhere in the Code except where the term is specifically defined differently."

A taxpayer is entitled to such consistency in definition. Where Congress and the Department of Treasury choose to employ a technical term such as "adjusted basis," a taxpayer must be given reasonable notice when the term is intended to have other than its ordinary meaning in the Code. Herein, no such notice was supplied, and plaintiffs calculated their taxes according to the ordinary meaning of the terms in the controlling statutes and the regulations. Taxpayers can be expected to do no more. Taxpayers are obliged to do no more.

Conclusion

For the reasons set forth above, plaintiffs' motion for summary judgment is granted and defendant's cross-motion is denied. The Clerk of the Court shall enter judgment for plaintiffs in the amounts of $30,963 for tax year 1981, and $18,733 for tax year 1982, plus statutory interest thereon.

IT IS SO ORDERED.

/s/ Roger B. Andewelt
ROGER B. ANDEWELT
Judge

APPENDIX C

UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

91-5032

WILLIAM F. HILL and LOLA E. HILL,
PLAINTIFFS-APPELLEES

v.

THE UNITED STATES, DEFENDANT-APPELLANT

NIES, *Chief Judge*, dissenting.

Congress has imposed a minimum tax on "items of tax preference" to insure that taxpayers with substantial economic income could not avoid significant tax liability by using exclusions, deductions, and credits. In general, for taxable years 1981 and 1982, the years at issue here, a minimum tax of 15 percent rate was imposed on a portion of the taxpayers' "items of tax preference." *See* 26 U.S.C. § 56(a) (1982).*

The particular "item of tax preference" at issue here concerns a deduction for depletion of a mineral deposit allowable under section 611. Under section 57(a)(8) of the Code, the portion of a depletion deduction that constitutes an "item of tax preference" is the excess of such deduction over the "adjusted basis of the property." The amount of depletion allowed for taxpayers' oil and gas deposits for taxable years 1981 and 1982 under section 611 is $439,884 and $371,636, respectively. The point of disagreement is over whether those amounts should be reduced by the unrecovered depreciated costs of certain machinery, pipes and equipment as a part of the "adjusted basis of the property." The amount of the depletion deduction subject to the alternative minimum tax as a tax preference item is then reduced to $233,339 and $240,420 in 1981 and 1982, respectively.

* All references are to the Internal Revenue Code, codified at Title 26 of the United States Code, applicable during 1981 and 1982, the tax years in issue.

Cost is the starting point for determining the "basis" of property. *See* 26 U.S.C. § 1012. Section 1016 then sets out what adjustments can be made to the cost and provides that "[p]roper adjustment in respect of the property shall in all cases be made—(1) for expenditures * * * properly chargeable to capital account." I disagree with the majority that this provision permits the costs of machinery and the like to be added as an "adjustment" to the "basis" of a mineral deposit so as to reduce the amount of a tax preference item for minimum tax purposes. The reason for my conclusion is the reference in section 57(a)(8) to section 614 for the definition of "property." Section 614(a) states that "the term property means each separate interest owned by the taxpayer *in each mineral deposit* . . . ." (Emphasis added.) Giving that definition to the term "property" where it appears in sections 57(a)(8) and 1016 means one must determine the adjusted basis of the mineral *deposit*.

A mineral *deposit* has a special meaning. As explained in the regulations, a mineral deposit may be part of a mineral *enterprise*. A mineral *enterprise* is defined in section 1.611-1(d)(3) as "the mineral de-

posit or deposits and improvements, if any, used in mining or in the production of oil and gas and only so much of the surface land as is necessary for purposes of mineral extraction." The distinction between a mineral deposit and a mineral enterprise must be made because only the mineral deposit itself is subject to a depletion allowance under section 611. In order to obtain that tax benefit, the taxpayer must maintain a separate capital account for the mineral deposit. *See* Treas. Reg. § 1.611-2(b)(1) (1982). The capital account of the mineral deposit on which depletion is calculated includes the cost of the deposit itself and certain exploration costs and other specific adjustments. It does not include the cost of improvements used in production, such as machinery and pipes. The latter are adjustments only to the enterprise. There is no disagreement here over what items enter into calculation of the basis of the property for purposes of the depletion allowance. However, when it comes to determining how much of the basis of the property has not been depleted, the majority allows an additional item to be added. Costs which are part of the capital account of the enterprise, per the majority, may be transferred over to the mineral deposit so as to reduce the minimum tax.

I see no reason, in logic or in the statute and regulations, why costs of capital improvements, which have nothing to do with the calculation of depletion under section 611 of the Code, should be added to the adjusted basis of the oil and gas deposits for purposes of reducing the alternative minimum tax. I agree with the government's analysis that inasmuch as only the deposits themselves are the "property" depletable under section 611, it is solely the adjusted basis of that "property" which must be deducted from the depletion allowance to arrive at the excess of depletion subject to the minimum tax. Section 57(a)(8) clearly envisions application of the same rules for tax preference purposes and calculation of tax preference items based on the same "property" for which the depletion deduction was calculated in the first place. The Claims Court found it conceivable that Congress could have decided that it would decrease the amount of the tax preference item by the amount of unrecovered depreciable property costs so as to encourage investments and improvements to oil and gas deposits by having the minimum tax not apply to the extent the taxpayers' costs for tangible improvements to the well have not yet been recovered. The trial judge concluded the statutory provisions result in that policy choice. I disagree. It appears to me that a straight forward as well as logical reading of the statute indicates its rejection.

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

91-5032

WILLIAM F. HILL and LOLA E. HILL,
PLAINTIFFS-APPELLEES

v.

THE UNITED STATES, DEFENDANT-APPELLANT

JUDGMENT

ON APPEAL from the UNITED STATES CLAIMS COURT in CASE NO. 679-88T

This CAUSE having been heard and considered, it is

ORDERED and ADJUDGED:

AFFIRMED.

ENTERED BY ORDER OF THE COURT

/s/ Francis X. Gindhart
FRANCIS X. GINDHART
Clerk

Dated Sep. 11, 1991

Issued as a Mandate: November 15, 1991

APPENDIX E

UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

91-5032

WILLIAM F. HILL and LOLA E. HILL,
PLAINTIFFS-APPELLEES

v.

THE UNITED STATES, DEFENDANT-APPELLANT

ORDER

Before NIES, Chief Judge, BENNETT, Senior Circuit Judge, and LOURIE, Circuit Judge.

A petition for rehearing having been filed in this case,

UPON CONSIDERATION THEREOF, it is

ORDERED that the petition for rehearing be, and the same hereby is, denied.

Chief Judge Nies would rehear the appeal.

The suggestion for rehearing in banc is under consideration.

The mandate will issue on November 15, 1991.

FOR THE COURT,
FRANCIS X. GINDHART

Clerk

Dated: November 8, 1991

cc: GARY R. ALLEN
RICHARD B. ROBINSON

APPENDIX F

UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

91-5032

WILLIAM F. HILL and LOLA E. HILL,
PLAINTIFFS-APPELLEES

v.

THE UNITED STATES, DEFENDANT-APPELLANT

ORDER

A suggestion for rehearing in banc having been filed in this case, and a response thereto having been invited by the court and filed,

UPON CONSIDERATION THEREOF, it is

ORDERED that the suggestion for rehearing in banc be, and the same hereby is, declined.

FOR THE COURT,
FRANCIS X. GINDHART

Clerk

Dated: December 19, 1991

cc: GARY R. ALLEN
RICHARD B. ROBINSON

APPENDIX G

IN THE UNITED STATES CLAIMS COURT

No. 679-88 T

WILLIAM F. and LOLA E. HILL

v.

THE UNITED STATES

JUDGMENT

Pursuant to the opinion of October 31, 1990, directing entry of judgment for plaintiffs,

IT IS ORDERED AND ADJUDGED this date, pursuant to Rule 58, that plaintiffs recover of and from the United States the sums of $30,963 for tax year 1981, and $18,733 for tax year 1982, plus statutory interest thereon, with costs to the prevailing party.

FRANK T. PEARTREE
Clerk of Court

October 31, 1990

By: /s/ Linda A. Eddins
Deputy Clerk

NOTE: As to appeal, 60 days from this date, see RUSCC 72. Filing fee is $105.00

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No. 91-1421

In The
Supreme Court of the United States
October Term, 1991

UNITED STATES OF AMERICA,
Petitioner,
v.

WILLIAM F. HILL AND LOLA E. HILL,
Respondents.

Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Federal Circuit

BRIEF IN OPPOSITION

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QUESTION PRESENTED

Whether the unrecovered cost of depreciable improvements to an oil and gas mineral deposit may be properly included in the adjusted basis of that property under Section 57(a)(8) of the Internal Revenue Code, for purposes of calculating the amount of depletion which constitutes a tax preference item subject to the minimum tax.

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No. 91-1421

In The

Supreme Court of the United States

October Term, 1991

UNITED STATES OF AMERICA,

Petitioner,

v.

WILLIAM F. HILL AND LOLA E. HILL,

Respondents.

Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Federal Circuit

BRIEF IN OPPOSITION

STATUTES AND REGULATIONS INVOLVED

I. Section 57 of the Internal Revenue Code,[1] 26 U.S.C. 57 provides in relevant part:

> (a) *In General.* – For purposes of this part, the items of tax preference are –
>
> * * *
>
> (8) *Depletion.* – With respect to each property (as defined in Section 614), the excess of the deduction for depletion allowable under

[1] All references to "IRC", "Code", "Internal Revenue Code", or "Section" in this Brief mean Title 26 U.S.C., the Internal Revenue Code of 1954, as amended to the tax years at issue.

section 611 for the taxable year over the *adjusted basis* of the property at the end of the taxable year (determined without regard to the depletion deduction for the taxable year). (Emphasis added).

II. Section 1.57-1(h)(3) of the Treasury Regulations[2], 26 C.F.R. 1.57-1(h)(3):

(3) *Adjusted basis*. For the determination of the adjusted basis of the property at the end of the taxable year see *section 1016 and the regulations thereunder.* (Emphasis added).

III. Section 1.1016-1 of the Treasury Regulations, 26 C.F.R. 1.1016-1 provides in relevant part:

Section 1016 and Sections 1.1016-2 to 1016-10 inclusive, contain the rules relating to the adjustments to be made to basis of the property to determine the adjusted basis as defined in Section 1011.

IV. Section 1.1016-2(a) of the Treasury Regulations, 26 C.F.R. 1.1016-2(a):

(a) The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, *including the cost of improvements and betterments made to the property.* No adjustment shall be made in respect of any item which, under any applicable provision of law or regulation, is treated as an item not properly chargeable to capital account but is allowable as a

[2] All references to "Treasury Regulations" or "Treas. Reg." mean Treasury Regulations in effect for the tax years at issue, 26 C.F.R.

deduction in computing net or taxable income for the taxable year. For example, in the case of oil and gas wells no adjustment may be made in respect of any intangible drilling and development expense allowable as a deduction in computing net or taxable income. See the regulations under section 263(c). (Emphasis added).

STATEMENT

I. During 1981 and 1982, Respondents were engaged in the oil and gas business. The Internal Revenue Code allows the owner of an economic interest in an oil and gas deposit to deduct a reasonable allowance for depletion, when computing taxable income. Code Section 611(a). The depletion deduction is calculated in two ways – based upon cost depletion pursuant to Section 612, and based upon a fixed percentage of the income derived from the property pursuant to Section 613. The higher amount is then claimed as the Section 611 depletion deduction. Treas. Reg. Section 1.611-1(a)(1).

II. The Code also identifies two categories of improvements to an oil and gas deposit: "intangible improvements" and "tangible (depreciable) improvements." Intangible improvements include all expenditures by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas, such as expenditures for clearing ground, draining, road making, surveying, geological work, excavating, grading, and the drilling, shooting, and cleaning

of wells. Treas. Reg. Sections 1.612-4(a) and (b)(1). A taxpayer has the option of either expensing intangible costs (deducting them totally from income in the year they are incurred), or capitalizing them and recovering the cost through the depletion deduction. *See* Treas. Reg. Sections 1.612-4(a) and (b)(1). Tangible improvements include the cost of physical improvements to the oil and gas deposit used in the production of the oil and gas, such as pumps, well equipment, pipes and similar items. *See* Treas. Reg. Sections 1.611-5(b)(4) and 1.612-4(c)(1). Tangible improvements must be recovered through depreciation deductions. *See* Code Section 611(a), Treas. Reg. Section 1.611-5, and Treas. Reg. Section 1.612-4(c)(1).

III. Code Sections 56 and 57 establish a unique separate tax scheme which, through a minimum tax, effectively recaptures certain deductions otherwise allowed under the Code. Each item of tax preference described in Section 57, relates to a specific deduction allowable in a separate section of the Code. (*See* Pet. App. 18a). The tax law *does not*, however, subject all of these tax deductions to the minimum tax. Rather, the minimum tax provisions merely provide a formula for determining how much, *if any*, of the intended regular tax benefit provided by these enumerated tax deductions, will be cut back, or recaptured.[3] Code Section 57(a)(8) provides rules for determining how much of a taxpayer's depletion deductions constitute tax preference items and, therefore, are subject to the minimum tax. Congress specified in Code Section

[3] Code Section 56(a) imposed a 15% minimum tax on the sum of a taxpayer's items of tax preference over certain specified deductions.

57(a)(8), that the depletion claimed during a taxable year with respect to a taxpayer's oil and gas mineral deposit, constitutes a tax preference item and is subject to the minimum tax, only to the extent such depletion exceeds the taxpayer's *adjusted basis* for such property.

IV. Pursuant to Code Section 57(a)(8) and Treas. Reg. Section 1.57-1(h)(3), Respondents calculated their depletion as a tax preference item by including the unrecovered costs of depreciable improvements to their mineral deposits in adjusted basis. The Internal Revenue Service disputed Respondents' calculation and asserted that additional taxes were due. Respondents paid the resulting deficiencies under protest, and filed refund claims, which the IRS denied. Thereafter, Respondents filed suit for refund in the Claims Court.

V. On Cross Motions for Summary Judgment, the Claims Court held that pursuant to Code Section 57(a)(8) Respondents were entitled to include the unrecovered costs of depreciable improvements (*e.g.*, tangibles) in the adjusted basis of their oil and gas mineral deposits. The Court of Appeals affirmed and adopted the opinion of the Claims Court.

VI. There are at least four misstatements of fact or law in the Government's Petition which Respondents desire to bring to the Court's attention:

A. The Petition erroneously states that the Court of Appeals found no "clear indication" in the statute to guide its decision. (*See* Pet. 7). In fact, the decision relies on the plain language of Code Section 57(a)(8) and the related Regulations. The Claims Court and, by adoption, the Court of Appeals, stated as follows:

> "When interpreting Code Section 57(a)(8), absent a clear indication in the Code or Regulations to the contrary, the ordinary Section 1016 meaning of the term adjusted basis should apply." (Pet. App. 11a).

Rather than finding such a contrary indication, the Claims Court found that "Treas. Reg. Section 1.57-1(h) requires that the taxpayer resort to the rules in Section 1016 and related Regulations to calculate the adjusted basis [of property]". (Pet. App. 15a). In this regard, it should be noted that the Petition has failed to discuss or even acknowledge the provisions of the Treasury Department's own Regulations which provided the authority for the Claims Court's decision. *See* Treas. Reg. Section 1.57-1(h)(3), and Treas. Reg. Section 1.1016-2(a). This omission is notable, since Petitioner is required to follow its own Regulations.

B. The decision did not, as the Petition maintains, improperly expand the definition of the term "property" as incorporated in Code Section 57(a)(8) to include depreciable improvements. (Pet. 7, 9, 11, and 13, ftn. 9). This case involves the calculation of the *adjusted basis* of a mineral deposit, not the definition of a mineral deposit. *See* Question Presented.

C. The Petition is incorrect in stating that the legislative history of Section 57(a)(8) supports its position. (Pet. 11). After a detailed review of the legislative history, the Claims Court found that "there are brief statements that arguably benefit each side, but nothing definitive." (Pet. App. 15a, ftn. 10). The Senate Finance Committee Report S. Rep. No. 91-552, 91st Cong. 1st Sess. (1969) cited by the Petition (Pet. 11) was, as the Claims

Court points out, modified by the Conference Committee, H.R. Conf. Rep. No. 91-782, 91st Cong. 1st Sess. (1969) so that the basis of the mineral deposit used to measure the tax preference for depletion is its "adjusted basis" and not its "cost basis."[4] (Pet. App. 15a-17a, ftn. 10). Moreover, the Petitioner has previously admitted, both before the Claims Court and the Court of Appeals, that the legislative history was "not all that helpful." (Pet. App. 15a, ftn. 10). Therefore, the Claims Court correctly concluded, that the critical focus when interpreting Code Section 57(a)(8), must be the *words* of the statute and the related Regulations. *See United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 242 (1989); *J. H. Miles & Co. v. U.S.*, 3 Cl. Ct. 10, 13 (1983). (Pet. App. 10a). In drafting Code Section 57(a)(8), Congress chose the words "adjusted basis" to measure the amount of depletion that constitutes a tax preference item. Treas. Reg. Section 1.57-1(h)(3) implements this choice by directing that, Section 1016's meaning of the term "adjusted basis" must apply and Treas. Reg. Section 1.1016-2(a)'s requirement that improvements must be included in adjusted basis must be followed.[5]

---

[4] The Petition incorrectly states that the "cost basis" of the property is the proper measure of the depletion tax preference item. (*See* Pet. 4, 10, and 11).

[5] Treas. Reg. Section 1.57-1(h)(3) was originally proposed on December 30, 1970 shortly after the enactment of Code Section 57(a)(8). The final regulations made no change in this language. See Federal Register Vol. 35, No. 252 p. 19765. A substantially contemporaneous construction by the Treasury Regulations is presumed to reflect Congressional intent. *See* Justice Blackmun's majority opinion in *National Muffler Dealers Association, Inc. v. United States*, 440 U.S. 472, 477 (1979) and

(Continued on following page)

D. Petitioner's contention that depreciable improvements are not a factor in determining the amount of depletion allowable as a tax deduction is incorrect. (*See* Pet. 10). Code Section 613(a) limits the amount of depletion which can be deducted, for tax purposes, to the gross income from the oil and gas deposit. It is the connection of depreciable improvements to these mineral deposits which allows production and, hence, gross income. In addition, Code Section 613(a) limits the depletion deduction to 50% of the taxable income from the mineral deposit. Taxable income is computed by subtracting various deductions, *including depreciation,* from the property's gross income. Treas. Reg. Section 1.613-5(a). Since Code Section 613(a) makes tangible improvements an integral part of the determination of the depletion allowance, it is only logical that they be included in the calculation of how much depletion will be considered as a

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(Continued from previous page)

also the dissent at p. 489 joined by Justice (Now Chief Justice) Rehnquist and Justice Stevens. The 1986 Committee Report cited by Petitioner (Pet. 11) actually supports Respondents because the reference to the *adjusted basis* of the depletable property confirms that the Code Section 1016 meaning of that term should apply. The term depletable property no more defines what basis adjustments are appropriate under Section 1016 than does the term mineral deposit. It is the Treasury Regulations under Code Section 1016, which describe the proper calculation for adjusted basis. While helpful to Respondents, they acknowledge that the views of a 1986 Congress, as to the construction of a statute adopted many hears before by a 1969 Congress, have very little, if any, significance and are not part of the legislative history. *Weinberger v. Rossi,* 456 U.S. 25, 35 (1982); *Andrus v. Shell Oil Co.,* 446 U.S. 657, 665, ftn. 8 (1980); and *Oscar Mayer & Co. v. Evans.* 441 U.S. 750, 758 (1979).

tax preference item under the formula set forth in Code Section 57(a)(8).

REASONS WHY THE PETITION SHOULD BE DENIED

I. THIS CASE DOES NOT CONFLICT WITH ANY DECISION OF THIS COURT OF ANY OTHER COURT. FURTHER REVIEW IS NOT WARRANTED.

A. There is No Conflict of Decisions.

There is currently no conflict between this case and any decision of this Court, any other court of appeals, or any lower federal trial court. Petitioner contends, however, that despite this lack of conflict, certiorari should be granted because it is unlikely that other courts of appeals will have an opportunity to review this same issue. (Pet. 9). *This contention is unquestionably erroneous.* There are at least two cases currently docketed in the U.S. Tax Court, *FMC Corporation and Subsidiaries v. Commissioner of Internal Revenue,* Dkt. 2016-90, and *E.I. DuPont deNemours & Company and Affiliated Corporations v. Commissioner of Internal Revenue,* Dkt. 19950-91, which involve the issue of whether depreciable improvements to a mineral deposit may be properly includable in adjusted basis for purposes of Code Section 57(a)(8). Given the sound reasoning behind the decision in this case, if Petitioner persists in its erroneous position, the U.S. Tax Court and other courts of appeal will have the opportunity to consider this issue. There is no reason to assume a conflict will develop. Accordingly, this Court should not depart from its usual practice of waiting to see whether an actual conflict develops.

B. This Case Does Not Present An Important Federal Question.

Petitioner's assertion of the alleged fiscal impact of this decision is unfounded and totally speculative.[6] The total refund claimed by Respondents, in this case, is only $49,426, plus statutory interest. If Petitioner wants a determination of the applicability of this oil and gas case to the hard mineral industry, (see Pet. 12 and 13) the cases currently docketed in the U.S. Tax Court (*see* paragraph A, above), are more appropriate vehicles, because they involve that *exact issue.* It is both inequitable to Respondents and premature to consider that issue by reviewing this case based on pure speculation as to its implications outside the oil and gas industry.

---

[6] Petitioner claims that including depreciable improvements in adjusted basis defeats the minimum tax. (Pet. 10). This claim is not true. In the instant case, even though Respondents included depreciable improvements in adjusted basis, they, nonetheless, reported $233,339 and $240,420 of depletion as a tax preference item in 1981 and 1982, and paid a minimum tax. (Pet. 6, ftn. 6)

II. THE COURT OF APPEALS CORRECTLY DECIDED THIS CASE BECAUSE IT APPLIED THE PRECISE FORMULA SET FORTH IN THE CODE AND REGULATIONS FOR CALCULATING DEPLETION AS A TAX PREFERENCE ITEM UNDER CODE SECTION 57(a)(8).

A. Code Section 57(a)(8) and the Related Regulations Provide a Formula for Determining Depletion as a Tax Preference Item.

Contrary to Petitioner's contentions (*see* Pet. 7 and 10), the Court of Appeals' decision applied the *precise formula set forth in the statute and the regulations* for calculating depletion as a tax preference item. Congress specified in Code Section 57(a)(8) that it is only the depletion claimed during the taxable year, with respect to each oil and gas mineral deposit, in excess of the taxpayer's *adjusted basis* for that property, which constitutes a tax preference item. The property, the adjusted basis of which must be determined under Code Section 57(a)(8), is defined in Code Section 614 to mean "each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land."

The Regulations under Code Section 57(a)(8) specify that the adjusted basis of a mineral deposit, *is determined under Code Section 1016 and the related Regulations. See* Treas. Reg. Section 1.57-1(h)(3). The term "adjusted basis" is precisely defined in the Code and Regulations. The adjusted basis of an oil and gas mineral deposit is its initial cost basis determined under Section 1012, *adjusted as provided in Code Section 1016. See* Code Section 1011(a) and Treas. Reg. Section 1.1011-1. Treas. Reg. Section 1.1016-2(a) provides, in pertinent part, as follows:

"(a) The cost or other basis shall be properly adjusted for any expenditure . . . or other item, properly chargeable to capital account, *including the cost of improvements or betterments made to the property* . . . ". (Emphasis added).

Since the Code and Regulations specify that the adjusted basis of a mineral deposit, for purposes of Code Section 57(a)(8), *must be increased by the costs of all improvements or betterments made to that property*, the Court of Appeals correctly concluded that depreciable improvements to a mineral deposit must be included in adjusted basis for purposes of Code Section 57(a)(8).

B. The Definition of "Property" Under Code Section 614 Does Not Exclude Depreciable Improvements From the Adjusted Basis of a Mineral Deposit.

The definition of "property", incorporated by Section 57(a)(8) from Section 614, does not require that depreciable improvements to a mineral deposit be excluded from the adjusted basis of that mineral deposit. (*See* Pet. 9). Everyone is in agreement that the property whose *adjusted basis* must be determined, for purposes of Code Section 57(a)(8), is each separate mineral deposit.[7] But the definition of property as the mineral deposit, is only the *starting point* for the calculation of adjusted basis. (*See* Pet. App. 15a and the Question Presented).

[7] As the Treas. Regulations indicate, the Section 57(a)(8) reference to Section 614 is intended to insure a separate calculation of adjusted basis for each separate mineral deposit. Treas. Reg. Section 1.57-1(h)(1). (Pet. App. 11a).

Section 614 does not provide any rules for determining what adjustments to the cost basis of a mineral deposit are appropriate when calculating adjusted basis. Pursuant to Treas. Reg. Section 1.57-1(h)(3), that subject is covered by Section 1016. In turn, Treas. Reg. Section 1.1016-2(a) provides that the *adjusted basis* of the mineral deposit includes the *cost of improvements or betterments made to the property*. Therefore, any expenditure which constitutes an improvement or betterment to a mineral deposit must be included in adjusted basis under Section 57(a)(8) and the related Regulations.[8]

As the Claims Court found, Petitioner's argument that depreciable improvements are not considered when calculating the adjusted basis of the mineral deposit, is inconsistent with the undisputed way in which Petitioner treats intangible improvements to a mineral deposit. (Pet. App. 15a). Petitioner has admitted that the adjusted basis of a mineral deposit includes intangible improvements, such as road making, clearing ground, excavating, and grading. (*See* Pet. 5, 11, and Pet. App. 6a). However, these intangible improvements are no more mineral deposits than are tangible improvements, such as pumps, well equipment, and pipes. *Both* tangibles and intangibles are

[8] As the Claims Court noted the issue in this case does not involve the calculation of the amount of the depletion deduction *per se*. The issue here involves the calculation of the amount of the depletion deduction that constitutes an item of tax preference and, hence is subject to the minimum tax. (Pet. App. 9a)

improvements to the mineral deposit because they enhance its value and utility.[9]

This glaring inconsistency in Petitioner's argument is also found in Petitioner's reliance on the definition of mineral enterprise as authority for its position. (Pet. 9). Treas. Reg. Section 1.611-1(d)(3) defines a mineral enterprise as the mineral deposit or deposits and improvements, if any, used in the production of oil and gas. Nothing in the definition of mineral enterprise addresses what constitutes an improvement to a mineral deposit within the meaning of Treas. Reg. Section 1.1016-2(a). Yet, Petitioner asserts that intangible improvements, such as road making, can be added to the basis of the mineral deposit under Code Section 57(a)(8), while tangible improvements, such as pumps and pipes cannot. (*See* Pet. 5, and Pet. App. 6a and 11a). There is nothing in the definition of a mineral enterprise which justifies this distinction. It is merely a "red herring" which attempts to distract this Court's attention from the plain language of Code Section 1016.

C. Code Section 1016 Requires That All Improvements (Both Tangible and Intangible) Must be Added to the Adjusted Basis of a Mineral Deposit.

Petitioner is in effect trying to create a special rule under Code Section 57(a)(8) to exclude tangible improvements when computing adjusted basis for minimum tax

---

[9] "*Improvements*: A valuable addition made to property or an amelioration in its condition, amounting to more than mere repairs . . . intended to enhance its value, beauty or utility or to adapt it for new or further purposes." *See Black's Law Dictionary*, 5th Ed. p. 682.

purposes. There is no authority for such a special rule in either Treas. Reg. Section 1.57-1(h)(3) or Treas. Reg. Section 1.1016-2(a). Petitioner cannot point to any statute or regulation which contradicts the plain language of Treas. Reg. Section 1.1016-2(a), that *all improvements or betterments* to a mineral deposit increase adjusted basis. There is nothing in the language of Treas. Reg. Section 1.1016-2(a) which even remotely distinguishes between the treatment of tangible and intangible improvements to a mineral deposit.[10] *See also*, Treas. Reg. Section 1.1016-2(b), Example. As the Claims Court noted: "Treas. Reg. Section 1.1016-2, which implements Section 1016, in turn provides that costs of improvements

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[10] Both the Courts and the IRS have recognized the interchangeable nature of the unrecovered costs of tangible and intangible improvements to a mineral deposit for tax purposes. In *E.C. Laster v. Commr.*, 43 B.T.A. 159 (1940), *acq.* on other issues, 1941-1 C.B. 7, and 1954-1 C.B. 5, *modified* on another issue, 128 F.2d 4 (5th Cir. 1942), Rev. Rul. 69-332, 1969-1 C.B. 87, and Rev. Rul. 71-207, 1971-1 C.B. 160, taxpayers were required to transmute the unrecovered costs of tangible improvements into unrecovered costs of intangible improvements. Such a result is only permissible if both tangibles and intangibles are included in the adjusted basis of a mineral deposit. In Rev. Rul. 68-361, 1968-2 C.B. 264, the IRS held that rental received from the lease of well equipment was "gross income from the property" under Code Section 613(a). If tangible improvements are not included in the adjusted basis of the mineral deposit, their rental income would not be gross income from the mineral deposit under Code Section 613(a). In TAM 8314011 (Dec. 22, 1982), the IRS ruled that unamortized deferred mine development costs (which under Code Section 616(a) include depreciation deductions) *were includible in adjusted basis for minimum tax purposes, even though they were not subject to depletion.* Technical Advice Memorandums are cited here as being representative of the IRS' administrative position. *See Rowan Companies, Inc. v. U.S.*, 452 U.S. 247 (1981), ftn.17, and *Hanover Bank v. Commr.*, 369 U.S. 672, 686-687 (1962).

and betterments to property that are not deductible (*i.e.*, not expensed) are expenditures properly chargeable to capital account and, hence, should be considered when calculating the 'adjusted basis'." (Pet. App. 7a).[11]

Furthermore, by providing that basis adjustments will be made for expenditures, "*including the cost of improvements or betterments to the property*", Treas. Reg. Section 1.1016-2(a) clearly envisions a basis increase for all improvements or betterments to the mineral deposit without regard to whether they are tangible or intangible. The word "including" is a term of enlargement, not of limitation. *See Tele-Communications, Inc. v. Commr.*, 95 T.C. 495 (1990) and 2A Sutherland's "Statutory Constructions", § 47.07, p.152 (5th Ed. 1992).

[11] *See* Treas. Reg. Section 1.162-4 and Treas. Reg. Sections 1.263(a)-1(a) and (b). The general rule is that a taxpayer cannot expense "any amounts paid for . . . permanent improvements or betterments made to increase the value of any property." *See also United States of America v. The Albertson Company*, 219 F.2d 920 (9th Cir. 1955) ("Certain expenditures are chargeable to capital account and therefore must be capitalized"); *Ralph E. Purvis v. Commr.*, 65 T.C. 1165, 1168 (1976) (Chargeable to capital account is used in the customary sense of capitalization). Section 1016 is the opposite face of the tax deduction coin . . . "if the deduction is denied because the outlay adds to the value of property or substantially prolongs its life, an increase in basis is, *ipso facto*, warranted." Bittker and Lokken "Federal Taxation of Income, Estates and Gifts", Section 42.1, p. 42-3.

D. Treas. Reg. Sections 1.612-1(a) and 1.612-1(b)(1) Confirm That Tangible Improvements Are Included in the Adjusted Basis of A Mineral Deposit Under Code Section 57(a)(8).

There is one situation, in which taxpayers are directed to deviate from the *general rule* of Code Section 1016 and to distinguish between tangible and intangible improvements for purposes of calculating the adjusted basis of a mineral deposit. This exception creates a *special rule* which specifically excludes "amounts recoverable through depreciation" from adjusted basis, *solely for purposes of calculating cost depletion*. Treas. Reg. Sections 1.612-1(a) and (b)(1) provide, in pertinent part, as follows:

> "Section 1.612-1. *Basis for allowance of cost depletion.*
>
> (a) *In general* – The basis upon which the deduction for cost depletion under section 611 is to be allowed in respect of any mineral or timber property is the adjusted basis provided in section 1011 for the purpose of determining gain upon the sale or other disposition of such property *except as provided in paragraph (b) of this section*. The adjusted basis of such property is the cost or other basis determined under section 1012, relating to the basis of property, *adjusted as provided in section 1016, relating to adjustments to basis, and the regulations under such sections* . . . . (Emphasis added).
>
> (b) *Special rules* – (1) The basis for cost depletion of mineral or timber property does not include:
>
> (i) Amounts recoverable through depreciation deductions, . . . "

The "special rule", provided in Treas. Reg. Sections 1.612-1(a) and (b)(1), for computing the adjusted basis of a mineral deposit for cost depletion, which explicitly excludes tangibles, *must be contrasted* with the language of the Section 57(a)(8) Regulations, which contain no such "special rule" for determining adjusted basis for calculating depletion as a tax preference item. To the contrary, Treas. Reg. Section 1.57-1(h)(3) mandates the ordinary Section 1016 procedure by stating: *"For the determination of the adjusted basis of the property at the end of the year, see Section 1016 and the Regulations thereunder"*. By specifying that for Code Section 612 cost depletion purposes, a "special rule" applies under which tangibles are excluded from the adjusted basis of the property, Treas. Reg. Section 1.612-1 implicitly acknowledges that, absent a special rule, the adjusted basis of the mineral deposit would include depreciable improvements.

This regulation is the "Achilles heel" in Petitioner's argument. It negates all of Petitioner's attempts to create a theoretical justification for its deviation from the plain language and ordinary meaning of the words of Section 57(a)(8), Section 1016, and the related regulations, by references to such concepts as the "definition of property"; or a "mineral deposit versus the mineral enterprise distinction"; or a "separate capital account rule." Treas. Reg. Sections 1.612-1(a) and (b)(1) illustrate that none of Petitioner's concepts address the true issue of how to compute adjusted basis under Section 1016.

III. THE COURT OF APPEAL CORRECTLY DECIDED THIS CASE BECAUSE PETITIONER IS BOUND TO FOLLOW ITS OWN REGULATIONS.

Taxpayers are entitled to rely on the literal language of the regulations. Treasury Regulations are binding on the Petitioner, as they are on the taxpayers.[12] This is the very basis of our self-assessment tax system. Fairness in the tax system requires that taxpayers be able to follow the literal language of the Regulations.[13]

Treas. Reg. Section 1.57-1(h)(3) and Treas. Reg. Section 1.1016-2(a) unequivocally direct taxpayers to include the costs of improvements and betterments in the adjusted basis of a mineral deposit for purposes of Code Section 57(a)(8), without regard to whether they are tangible or intangible improvements. If the result of the literal language of the Petitioner's own Regulations produces, what the Internal Revenue Service perceives to be, an

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[12] *Pacific National Bank of Seattle v. Commr.*, 91 F.2d 103, 105 (9th Cir. 1937). *See, also, Lansons, Inc. v. Commr.*, 622 F.2d 774, 776 (5th Cir. 1980); *Mutual Savings Life Insurance Co. v. U.S.*, 488 F.2d 1142, 1145 (5th Cir. 1974); *Brafman v. U.S.*, 384 F.2d 863, 866 (5th Cir. 1967); and *McCord v. Granger*, 201 F.2d 103, 106 (3rd Cir. 1952).

[13] The articles cited by petitioner (Pet. Ftn. 7) criticize the Court of Appeals' decision as following too closely the precise language in the statute and regulations. The two commentators are conceding that the literal language of the Code and Regulations produces the result reached by the Court of Appeals, but they set forth the surprising *ipse dixit* proposition that the Petitioner can ignore its own regulations, if they produce, what it perceives to be, an undesirable result. This proposition is clearly contrary to established precedent. *See* ftn. 12, *supra*.

unintended or anomalous result, the Petitioner should amend its Regulations. However, when the Petitioner has not taken steps to amend its Regulations,

> "[the] Government's failure to use its broad power in this area does not justify judicial interference in what is, essentially, a legislative and administrative matter."[14]

CONCLUSION

The Claims Court and the Court of Appeals properly rejected the Government's request to retroactively rewrite the Code and Regulations. The Petition for a Writ of Certiorari should be denied.

Respectfully submitted,

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[14] *Woods Investments Co. v. Commr.*, 85 T.C. 274, 282 (1985); See also *Henry C. Beck Builders, Inc. v. Commr.*, 41 T.C. 616, 628 (1964); *Transco Exploration Co. v. Commr.*, 95 T.C. 373, 384 (1990), *aff'd.* 949 F.2d 837 (5th Cir. 1992); *T. Jack Foster v. Commr.*, 25 T.C.M. 1390, 1417 (1966); *Idaho First National Bank v. Commr.*, 95 T.C. 185, 192,(1990) ftn. 14; and *Honeywell, Inc. v. Commr.*, 87 T.C. 624, 635 (1986).

(3)

No. 91-1421

In the Supreme Court of the United States

OCTOBER TERM, 1991

UNITED STATES OF AMERICA, PETITIONER

v.

WILLIAM F. HILL AND LOLA E. HILL

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

KENNETH W. STARR
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Washington, D.C. 20530
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In the Supreme Court of the United States

OCTOBER TERM, 1991

No. 91-1421

UNITED STATES OF AMERICA, PETITIONER

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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1. As we explain in the petition (Pet. 12-14), the decision of the court of appeals threatens to shelter billions of dollars of preference income that Congress intended to tax. Although respondents recognize that the Federal Circuit is a court of national jurisdiction where most (if not all) such claims will be litigated (see Pet. 9, 12-14), respondents assert that there is no need for immediate review because two cases are pending in the Tax Court that now raise the same issue (Br. in Opp. 9).

The cases to which respondents refer were pending in the Tax Court when the decision in the instant case was issued. The taxpayers in those cases chose to amend their claims to seek a recomputation of the minimum tax under the rationale of the surprising *Hill* decision. We would not expect

taxpayers who did *not* have cases already pending in the Tax Court to choose to litigate the issue there, given the now favorable precedent in the Federal Circuit. It will be several years before those Tax Court cases could generate an appellate decision that might conflict with the decision in this case.

In the meantime, as indicated in the petition (Pet. 12), the Internal Revenue Service has received refund claims aggregating more than $400,000,000 in the relatively short time since this case was decided. It is apparent that many more such claims will be filed if the decision is permitted to stand. The decision will thus significantly disrupt and obstruct administrative resolution of large numbers of tax claims involving ultimately billions of dollars of revenues.

It is also unlikely that the taxpayers who are presently in the Tax Court will have incentive to pursue their claims further should they lose in that court. Even if a decision unfavorable to the taxpayers were issued for the years involved in those cases, in deciding whether to appeal, the taxpayers would be expected to consider whether an appeal would endanger the *Hill* decision and jeopardize the taxpayers' apparent certainty of receiving tax refunds on this same issue for their open (and future) taxable years not before the Tax Court. That would be tantamount to threatening the goose that lays golden eggs. It is thus improbable that the few taxpayers who found it necessary to assert this issue in the Tax Court would seek further review from an adverse Tax Court decision. The administrative and fiscal consequences of the decision of the court of appeals are, in any event, better dealt with now than later, after hundreds of expensive and time-consuming administrative claims and audits are needlessly conducted.

2. Contrary to respondents' arguments (Br. in Opp. 11-20), the Internal Revenue Code provides that the adjusted basis of a "mineral deposit" does not include the depreciable improvements that form part of the "mineral enterprise." Respondents do not dispute that "the adjusted basis of the property" referred to in Section 57(a)(8) of the Internal Revenue Code is, by specific reference to the definition of "property" in Section 614, the adjusted basis of each separate "mineral deposit." And, both parties agree that the adjusted basis of a mineral deposit for purposes of Section 57(a)(8) is to be determined under Section 1016 and its regulations. See 26 C.F.R. 1.57-1(h)(3). Section 1016 provides that the cost basis of any asset is to be adjusted "for expenditures * * * or other items[] *properly chargeable to capital account*" (26 U.S.C. 1016 (emphasis added)). In this regard, the Treasury Regulations provide (26 C.F.R. 1.1016-2(a)):

> The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, including the cost of improvements and betterments made to the property. No adjustment shall be made in respect of any item which, under any applicable provision of law or regulation, is treated as an item not properly chargeable to capital account but is allowable as a deduction in computing net or taxable income for the taxable year. For example, in the case of oil and gas wells no adjustment may be made in respect of any intangible drilling and development expense allowable as a deduction in computing net or taxable income. * * *

Respondents err, however, in contending that depreciable tangible property is "properly chargeable

to [the] capital account" (26 C.F.R. 1.1016-2(c)) of a "mineral deposit." The crux of respondents' error, and that of the courts below, lies in their refusal to recognize that the "mineral deposit" and the depreciable tangible improvements have their own *separate* capital accounts and, accordingly, separate bases. This is because, as explained in our petition (Pet. 3), the taxpayer is allowed a *separate* deduction for the depletion of the mineral deposit and for the depreciation of the costs of tangible improvements (26 U.S.C. 611).[1] As a result, separate capital accounts must be maintained for the mineral deposit and for the depreciable improvements. 26 C.F.R. 1.611-2(b)(1), 1.611-5(c).[2]

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[1] Historically, and theoretically, the depletion deduction reflects the principle that taxpayers with an economic interest in a mineral deposit must be able to recover their cost or investment in the mineral deposit before realizing income. The earlier Acts provided that depletion should be allowed on the basis of cost unless the taxpayer was the discoverer of the well upon an unproven tract, in which case the basis was the "value of the property" at the time of the discovery or within 30 days thereafter. *Palmer* v. *Bender*, 287 U.S. 551, 556 n.1 (1933). The Revenue Act of 1926, however, eliminated the "discovery value" provision and allowed the taxpayer to calculate depletion on the basis of cost alone, or else to deduct an arbitrary allowance, fixed by the statute, without reference to cost or discovery value, based on a percentage of gross income from the well. See *United States* v. *Dakota-Montana Oil Co.*, 288 U.S. 459, 461 (1933).

[2] The Treasury Regulations require every taxpayer claiming a deduction for depletion of mineral property to keep a separate account accurately recording the cost or other basis of such property as provided by Section 1012, together with subsequent allowable capital additions to each account and all of the other adjustments required by Section 1016. 26 C.F.R. 1.611-2(b)(1). They also provide that accounts for depreciable improvements are to be maintained in accordance with Section 1.167(a)-7, by treating each individual item as an account, or by combining two or more assets in a single account. 26 C.F.R. 1.611-5(c).

Pursuant to the plain language of the applicable statutes and regulations, the adjusted basis of the mineral deposit thus includes only the costs of improvements to the "mineral deposit" that are properly chargeable to *its* capital account.[3] The costs of depreciable improvements are therefore not properly added to the capital account of the mineral deposit under the regulations pertaining to depletion.

Respondents assert (Br. in Opp. 13-14) that it is inconsistent to include the costs of intangible improvements in the adjusted basis of the mineral deposit, but not the costs of tangible improvements. See note 3, *supra*. Nearly 60 years ago, however, this Court rejected the similar contention that there is no logical basis for distinguishing between tangible and intangible improvements to mineral property with respect to the recovery of their cost through the separate methods of depletion and depreciation. See *United States* v. *Dakota-Montana Oil Co.*, 288 U.S. 459 (1933). The taxpayer in that case sought to depreciate its capitalized intangible development costs. The government took the position that the claimed deduction was properly for depletion, rather than depreciation. The government's rationale was that the intangible expenses in drilling a well did not

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[3] Examples of costs that are properly chargeable to the capital account of a mineral deposit are the costs of acquiring the deposit and also the intangible drilling and development costs (IDC's)—such as amounts paid for labor, fuel, repairs, hauling, and supplies used in the drilling of wells or in the preparation for drilling—*if* the taxpayer elects to capitalize the costs rather than to deduct them. 26 C.F.R. 1.612-4(a).

create a tangible property that wears out with use or has a salvage value (*id.* at 462, 466). In holding for the government, the Court explained (288 U.S. at 465):

> development costs other than the cost of physical property incident to the development must be returned through the depletion allowance, but the regulations also provided expressly that the cost of "physical property such as machinery, tools, equipment, pipes, etc.," should be returned by an annual allowance for depreciation.

The Court noted that this distinction was continued under subsequent tax statutes until the provision respecting depletion was, in 1924, amended to provide for a reasonable allowance for depletion to be established under rules and regulations prescribed by the Commissioner. *Ibid.* The regulations that the Commissioner adopted have maintained this same distinction. See 26 C.F.R. 1.612-4(a) and (b).

Respondents recognize (Br. in Opp. 17-18), as they must, that Section 1.612-1(b) specifically provides that "the basis for cost depletion of mineral or timber property does not include * * * [a]mounts recoverable through depreciation deductions." Respondents are wrong, however, in arguing that this is a "special rule" that is not applicable to this case. As we have shown, it is the general rule that the costs of depreciable property are not to be included in the basis of the "mineral deposit" (regardless whether cost or percentage depletion is used) because such costs are not "properly chargeable" (26 C.F.R. 1.1016-2(a)) to the capital account of the mineral deposit.[4]

[4] The capital account, and hence the adjusted basis, for all mineral properties is calculated in the *same* manner, without regard to whether cost or percentage depletion is used. See 26 C.F.R. 1.611-2(b). The regulations covering the determination of percentage depletion under Section 613 do not specifically address basis, as does Section 1.612-1(b) dealing with cost depletion, because basis is not relevant in computing percentage depletion, which may be taken even though the property's entire basis has been recovered. See 26 C.F.R. 1.611-2(b)(2).

For the foregoing reasons, and those stated in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

KENNETH W. STARR
Solicitor General

APRIL 1992

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No. 91-1421

In the Supreme Court of the United States

OCTOBER TERM, 1991

UNITED STATES OF AMERICA, PETITIONER

v.

WILLIAM F. AND LOLA E. HILL

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

JOINT APPENDIX

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PETITION FOR A WRIT OF CERTIORARI FILED: MARCH 6, 1992
CERTIORARI GRANTED: APRIL 27, 1992

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In the Supreme Court of the United States

OCTOBER TERM, 1991

No. 91-1421

UNITED STATES OF AMERICA, PETITIONER

v.

WILLIAM F. AND LOLA E. HILL

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

JOINT APPENDIX

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IN THE UNITED STATES CLAIMS COURT

No. 679-88 T

WILLIAM F. and LOLA E. HILL

v.

THE UNITED STATES

DOCKET ENTRIES

DATE	PROCEEDINGS
Nov. 29, 1988	Complaint filed
Nov 29 1988	Filing fee of $60 paid by plaintiffs.
Nov 29 1988	Notice of assignment to Judge Roger B. Andewelt filed. Copy to parties.
Dec 12 1988	Defendant's notice of appearance filed. Service: 12/9/88.
Jan 25 1989	Defendant's motion for enlargement of time (to March 1, 1989) to respondent to complaint filed. Service: 1/25/89. ALLOWED: JAN 26 1989.
Mar 1 1989	Defendant's answer filed. Service: 3/1/89.
Apr 11 1989	Joint preliminary status report filed.
Apr 13 1989	Judge's order directing parties to complete discovery by August 30, 1989, with a joint status report due at that time filed. Copy to parties.
Aug 30 1989	Joint status report filed by defendant. Service: 8/30/89.

DATE	PROCEEDINGS
Sep 5 1989	Judge's order directing plaintiffs to file their motion for summary judgment by September 15, 1989, filed. Copy to parties.
Sep 15 1989	Plaintiffs' motion to amend complaint filed. Service: 9/14/89. APPROVED: SEP 19 1989.
Sep 15 1989	Plaintiffs' motion for summary judgment filed. Service: 9/14/89.
Sep 15 1989	Plaintiffs' proposed findings of uncontroverted facts filed. Service: 9/14/89.
Sep 19 1989	Plaintiffs' first amendment to complaint filed.
Oct 13 1989	Defendant's motion for enlargement of time (to December 14, 1989) to respond to motion for summary judgment filed. Service: 10/12/89. ALLOWED: OCT 18 1989.
Dec 12 1989	Defendant's motion for enlargement of time (to January 13, 1990) to respond to motion for summary judgment filed. Service: 12/12/89. ALLOWED: DEC 19 1989.
Jan 12 1990	Defendant's motion for enlargement of time (to January 23, 1990) to respond to motion for summary judgment filed. Service: 1/11/90. ALLOWED: JAN 12 1990.
Jan 23 1990	Defendant's motion for enlargement of time (to February 2, 1990) to submit its response to motion for summary judgment filed. Service: 1/23/90. ALLOWED: JAN 31 1990.
Jan 29 1990	Plaintiffs' response to motion for enlargement of time filed. Service: 1/26/90.
Feb 2 1990	Defendant's cross-motion for summary judgment filed. Service: 2/2/90.
Feb 2 1990	Defendant's statement of genuine issues and proposed findings of uncontroverted facts (one item) filed. Service: 2/2/90.

DATE	PROCEEDINGS
Feb 20 1990	Plaintiffs' reply brief filed. Service: 2/16/90.
Feb 20 1990	Plaintiffs' statement of genuine issues filed. Service: 2/16/90.
Mar 5 1990	Defendant's motion for enlargement of time (to March 15, 1990) to file its reply brief filed. Service: 3/5/90. ALLOWED: MAR 6 1990.
Mar 15 1990	Defendant's reply brief filed. Service: 3/15/90.
Sept 5 1990	Judge's order scheduling oral argument filed. Copy to parties.
Oct 31 1990	Judge's opinion filed. Copy to parties.
Oct 31 1990	Judgment entered that plaintiffs recover the sum of $49,696.00 plus interest with costs to the prevailing party. Copy to parties.
Nov 1 1990	Erratum with respect to the 10/31/90 opinion filed. ["Each party shall bear its own costs."]. Copy to parties.
Nov 2 1990	Certified copy of judgment forwarded to defendant. See letter in file.
Nov 19 1990	Transcript of proceedings (1 volume) taken at Washington, D.C., on October 15, 1990, filed. Notice to parties.
Dec 28 1990	Defendant's notice of appeal filed. Copy to plaintiff and C.A.F.C. No. 91-5032.

UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

91-5032

WILLIAM F. HILL and LOLA E. HILL,
PLAINTIFFS-APPELLEES

v.

THE UNITED STATES, DEFENDANT-APPELLANT

DOCKET ENTRIES

DATE	PROCEEDINGS AND ORDERS
December 28, 1990	Notice of appeal filed by Defendant in US Claims Ct. (bah)
December 28, 1990	Notice of appeal and certified list, received. (bah)
	COUNSEL FOR THE APPELLANT: Gary R. Allen
	MOB ——— BAS ——— ———
	COUNSEL FOR THE APPELLEE: Richard B. Robinson
	MOB ——— BAS ——— ———
	Certificate of Interest for the Appellant, filed.
	Certificate of Interest for the Appellee, filed.
January 3, 1991	Notice of appeal and certified list, docketed. Notice sent to the parties. (bah)

DATE	PROCEEDINGS AND ORDERS
	1. BRIEF FOR APPELLANT AND JOINT APPENDIX REC'D 03/05/91. SENT REJECTION LETTER TO COUNSEL RE BRIEF FOR PETITIONER/JOINT APPENDIX FOR THE FOLLOWING REASON: NON-COMPLIANCE WITH CAFC RULE 32.E(1), 28.A(12), AND 30(4). MAILED: 03/08/91 (EOD 03/08/91) (SP) 91-5032
March 4, 1991	BRIEF FOR APPELLANT, filed. (MS-3/4) (sp)
April 11, 1991	BRIEF FOR APPELLEES, filed. (HS-4/11) (sp)
	2. APPELLANT—MOTION FOR EXT OF TIME FOR FILING BRIEF. (MS-04/18/91) FILED: 04/18/91. ACTION ON MOTION (3): GRANTED; TO AND INCL MAY 7, 1991. BY MOTIONS PANEL. JUDGE: RICH. FILED: 04/25/91. (EOD 04/25/91 BY SCG) 91-5032
April 30, 1991	4. PANEL 06I+ on June 7 CALENDAR LETTER RE ARGUMENT sent to Allen/Robinson (df) [REASSIGNED TO PANEL I+]
May 7, 1991	REPLY BRIEF FOR APPELLANT, filed. (MS-5/7) (sp)
May 7, 1991	JOINT APPENDIX, filed. (MS-3/4) (sp)
June 7, 1991	Argued. (Nies CJ, Bennett SJ and Lourie J) (atk)
September 11, 1991	AFFIRMED. (Bennett, SJ) "JUDGMENT ENTERED" (bah) NIES, *Chief Judge*, dissenting.

DATE	PROCEEDINGS AND ORDERS
	5. APPELLANT—MOTION FOR EXT OF TIME FOR FILING PETITION FOR REHEARING. (MS-09/17/91) FILED: 09/18/91. REPLY 1 (6) FILED: 09/18/91. ACTION ON MOTION (5): GRANTED, TO AND INCL OCT. 25, 1991. BY MERITS PANEL. FILED: 09/24/91. (EOD 09/24/91 BY SCG) 91-5032
October 25, 1991	APPELLANT—COMBINED PETITION FOR REHEARING AND SUGGESTION FOR REHEARING IN BANC (MS-10/25/91 FILED: 10/25/91 PETITION CIRCULATED: 10/28/91 PETITION DISPOSITION: 11/08/91 ACTION: DENIED. SUGGESTION CIRCULATED: 11/08/91 RESPONSE REQUESTED FROM: APPELLEE (U.S.) RESPONSE DUE: 12/05/91 RESPONSE FILED: 12/05/91 RESPONSE CIRCULATED: 12/09/91 SUGGESTION DISPOSITION: 12/19/91 ACTION: DECLINED. (EOD 12/19/91 BY (CS) 91-5032
November 15, 1991	MANDATE ISSUED TO THE U.S. CLAIMS COURT. (BAH)
November 20, 1991	7. Phone conversation and letter to appellee requesting a response to appellant's suggestion in banc on or before 12/5/91 (cs)
January 29, 1992	8. Extension of time to file a petition for a writ of certiorari gra 01/27/92, extending the time to and including 3/7/92 (cs)
	PETITION FOR WRIT OF CERTIORARI FILED 03/06/92, SUPREME COURT #: 91-1421. (EOD 03/16/92 BY CS) 91-5032

DEFENDANT'S STATEMENT OF GENUINE ISSUES PROPOSED FINDINGS OF FACT

[5] (Pltf. Proposed Findings 6 and 8, and citations thereto, including Ex. 3 at pp. 34 and 54.)

8. On Form 4625 ("Computation of Minimum Tax-Individuals"), attached to each federal income tax return for 1981 and 1982, the plaintiffs calculated percentage depletion as a tax preference item for purposes of the minimum tax (Section 56 et seq. of the Internal Revenue Code of 1954), using the following methodology:

a. First, plaintiffs' adjusted basis for each oil and gas property prior to claiming percentage depletion was calculated by expensing intangible costs and intangible drilling and development costs, and capitalizing tangible costs recoverable through depreciation.

b. Second, plaintiffs annually reduced the adjusted basis of each property by the depreciation claimed with respect to tangibles and by the percentage depletion claimed for such property.

c. Finally, plaintiffs subtracted their remaining adjusted basis, if any, for unrecovered intangible costs and unrecovered tangible costs, for each property, as calculated above, from the percentage depletion claimed for that property during the year. The excess, if any, was reported as a tax preference item. The minimum tax so calculated and returned by plaintiffs was $29,812 for 1981 and $26,736 for 1982. (Pltf. [6] Proposed Finding 7, and citation thereto, including Ex. 1 at p. 13, and Ex. 2 at p. 25.)

9. The plaintiffs' method of computing percentage depletion as a tax preference item was also challenged by the IRS upon examination. The IRS, and the defendant herein, maintain that in computing the amount of percentage depletion as a tax preference item only the unrecovered intangible costs may be subtracted from the allowable percentage depletion, and not both the unrecovered intangible costs and unrecovered tangible costs, as plaintiffs maintain. (Pltf. Proposed Finding 9, and citations thereto; Compl. para. 7; plaintiffs' claim for

refund for 1981, Complaint Ex. B, and claim for refund for 1982, Ex. 9 cited in Pltf. Proposed Finding 9, and the IRS Notice of Disallowance of plaintiffs' claims for refund, Ex. 10 cited in Pltf. Proposed Finding 9, at pp. 124, 129-130.)

10. In this action, the plaintiffs maintain that the correct method of computing percentage depletion as a tax preference item, after taking into account the modifications to the percentage depletion allowable proposed by the IRS and agreed to by plain-tiffs, is as follows, resulting in the stated amounts of percentage depletion as a tax preference item:

[7]

	1981	1982
1. Depletion allowable	$439,884	$371,636
Less: unrecovered intangible costs	—0—	—0—
Less: unrecovered tangible costs	206,545	131,216
2. Depletion as a tax preference item	$233,269	$240,420

(Pltf. Proposed Finding 8, and citations thereto; Deft. Proposed Findings 4-7.)

11. In this action, the defendant maintains that the correct method of computing percentage depletion as a tax preference item, after taking into account the modifications to the percentage depletion allowable proposed by the IRS and agreed to by plaintiffs, is to subtract from the percentage depletion allowable the amount of any unrecovered intangible costs—which amount in this case is zero—with no amount of any unrecovered tangible costs being allowed as a reduction. The computation and stated amounts of percentage depletion as a tax preference item are as follows:

	1981	1982
1. Depletion allowable	$439,884	$371,636
Less: Unrecovered tangible costs are never allowed as a reduction:	—0— —0—	—0— —0—
2. Depletion as a tax preference item	$439,884	$371,636

(Pltf. Proposed Findings 9, 10, and 12, and citations thereto, especially Ex. 3 at pages 79-81.)

JOINT APPENDIX IN THE COURT OF APPEALS

[5] And that's at pages 43, 44 and 45 of my opening brief.

THE COURT: Yeah.

MR. PHILPOTT: And actually I was going to bring it up in argument. We look for a picture of the separation and depletion and depreciation items. For example, on page 45, it says, "Recovery of optional loans if taxwise. One, items returnable through depletion:," on and on and on. It says, "Insofar as they are not presented by personal property." Then note two, it says, "Items returnable through depreciation." So, there is a separation and your question was quite relevant.

THE COURT: Okay, now. Let's talk about the intangibles that are recovered through depletion and not through deduction, not through depreciation. Are these added to the basis in calculating the adjusted basis, Defendant?

MR. PHILPOTT: Could you repeat that?

THE COURT: With respect to those intangible costs, that are not expense, and that are properly recovered through depletion, the depletion deduction—

MR. PHILPOTT: Yes?

THE COURT: Are those costs added to the basis in calculating the adjusted basis?

MR. PHILPOTT: For purposes of Section 57?

[6] THE COURT: For purposes of Section 57.

MR. PHILPOTT: I would say yes.

THE COURT: They are?

MR. PHILPOTT: Yes.

THE COURT: Okay, thank you.

MR. PHILPOTT: It's a part, what we would argue as the depletable property. Right.

THE COURT: Well, okay. Okay. I'm ready to start arguing. But let me, if I can, I want to hear from the Government first, even though Plaintiff filed first. And that's because, I think the Plaintiff's argument, well, Plaintiff can obviously state it better than I can, it's rela-

tively straightforward. It starts with—what we're trying to determine is what the proper definition of adjusted basis is. And Plaintiff points that the regulation 1.571(h) states, "For the determination of the adjusted basis of the property at the end of the taxable year, see Section 101.6 and the regulations thereunder." Okay. Section 101.6 says, "Proper adjustment should be made for expenditures properly chargeable to the capital account." Okay.

What's properly chargeable to the capital account, I'd go to 101.6-2, which says, "The costs and other basis should be properly adjusted for any expenditure properly chargeable to the capital account, including the costs of [7] improvements and betterments made to the property." So, we have adjusted basis. You include expenditures properly chargeable to the capital account. And 101.6-2 seems to say that the cost of improvements and betterments made to properties are costs that are properly chargeable to the capital account. Now, 101.6115(b)(4) seems to say, that tangible costs are improvements to the property. Okay.

So, the regulations seems to point us, the regulations do point us to 101.6. They don't indicate any exception to the rules of 101.6. And 101.6 seems to oblige the taxpayer to add the cost of improvements.

What we have here are improvements. Are they not?

MR. PHILPOTT: Yes.

THE COURT: They are improvements? Okay. So you're saying, we don't do what 101.6, from my reading, seems to say, we are obliged to do.

So, why don't you pick up from there.

MR. PHILPOTT: If Your Honor will indulge me, could I, I have fully in mind your interests—

THE COURT: Handle it the way you want to handle it.

MR. PHILPOTT: Okay. I was going to try to, since I know you're fully familiar with the issue, what is the adjusted basis of the property for purposes of tax preference

* * * *

[38] MR. PHILPOTT: You'd have to use your common sense here. I mean, to say well, hey wait a minute, this is a sort of outrageous. It's too cursory a view of 1016, after what's gone on before. And you're viewing the tax preference, the minimum tax provision in the first place. 1016 is just a general section of a Code. Income tax 101 for the first year law students and all that. It's not a specific thing. I mean, you have to bring a lot to bear on 1016. And of course, I would direct your attention to the regs, 1016-6 of that. It's quoted in my Reply Brief.

THE COURT: What do you think you'd hear from the legislative history?

MR. PHILPOTT: In this regard, the legislative history isn't all that helpful. I've set out as much of it as possible on it. It does say that 614 is new, and they did, Congress did recognize a problem if property had not been defined as well as it should have been up to that point. So, 614 is new and then when they did put in 614 property, which is the economic interest in the mineral deposits. Other than that, I just think it carries on the dichotomy between depreciation and depletion and how cautious we ought to be when we're dealing in this area, which I wouldn't say is 100 percent crystal clear. But I would say with everything that's available, it's pretty much so.

* * * *

SUPREME COURT OF THE UNITED STATES

No. 91-1421

UNITED STATES, PETITIONER

v.

WILLIAM F. HILL, ET UX.

ORDER ALLOWING CERTIORARI

Filed April 27, 1992

The petition herein for a writ of certiorari to the United States Court of Appeals for the Federal Circuit is granted.

April 27, 1992

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(5)

No. 91-1421

In the Supreme Court of the United States

OCTOBER TERM, 1992

UNITED STATES OF AMERICA, PETITIONER

v.

WILLIAM F. HILL AND LOLA E. HILL

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE UNITED STATES

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3

QUESTION PRESENTED

Whether the unrecovered cost of depreciable tangible improvements to a mineral deposit may properly be included in the adjusted basis of that property in determining the amount of the depletion deduction that constitutes a tax preference item subject to the minimum tax under Section 57(a)(8) of the Internal Revenue Code, 26 U.S.C. 57(a)(8) (1976).

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In the Supreme Court of the United States

OCTOBER TERM, 1992

No. 91-1421

UNITED STATES OF AMERICA, PETITIONER

v.

WILLIAM F. HILL AND LOLA E. HILL

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a) is reported at 945 F.2d 1529.[1] The opinion of the Claims Court (Pet. App. 2a-23a) is reported at 21 Cl. Ct. 713.

JURISDICTION

The judgment of the court of appeals (Pet. App. 28a) was entered on September 11, 1991. The court of appeals denied the petition for rehearing on November 8, 1991 (Pet. App. 29a) and it declined the suggestion for rehearing en banc on December 19, 1991 (Pet. App. 30a). On January 27, 1992, the Chief Justice extended the time for filing the petition

[1] The court of appeals adopted the opinion of the Claims Court (Pet. App. 2a-23a).

for a writ of certiorari to March 7, 1992. The petition was filed on March 6, 1992, and was granted on April 27, 1992. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

STATUTE INVOLVED

Section 57 of the Internal Revenue Code of 1954, 26 U.S.C. 57 (1976),[2] provides, in pertinent part:

> (a) *In General.*—For purposes of this part, the items of tax preference are—
>
> * * * * *
>
> (8) *Depletion.*—With respect to each property (as defined in section 614), the excess of the deduction for depletion allowable under section 611 for the taxable year over the adjusted basis of the property at the end of the taxable year (determined without regard to the depletion deduction for the taxable year).
>
> * * * * *

STATEMENT

During 1981 and 1982, respondents were engaged in the business of oil and gas exploration, development, and production (Pet. App. 3a). This case concerns the proper calculation of the amount of the percentage depletion deduction that they took in those

[2] Subsection 57(a)(8) of the Code was redesignated as Subsection 57(a)(1) for taxable years beginning after 1986. This change was part of a revision of Section 57 made in the course of enacting the Internal Revenue Code of 1986. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 701(a) and (f)(1), 100 Stat. 2333, 2343. Unless otherwise specifically stated, citations in this brief will be to the Internal Revenue Code as in effect during 1981 and 1982, the years at issue in this case.

years that constitutes a "tax preference" item under Section 57(a)(8) of the Internal Revenue Code, 26 U.S.C. 57(a)(8) (1976), and is therefore subject to the minimum tax imposed by Section 56 of the Code, 26 U.S.C. 56.

1. Section 611 of the Code allows taxpayers with an economic interest in oil, gas, or other mineral deposits to deduct from their gross income (i) a reasonable allowance for the depletion of the mineral deposit and (ii) a reasonable allowance for the depreciation of tangible improvements to the mineral property (*e.g.*, machinery, tools, equipment, pipes, and similar items). 26 U.S.C. 611 (1976). The allowance for depreciation of "tangible" improvements reflects the general rule that a taxpayer is allowed to recover the *costs* of acquiring tangible business property over its useful life; once these costs have been fully recovered through annual depreciation deductions, no additional deductions are allowed. See 26 U.S.C. 167(g), 1016(a)(2). By contrast, the percentage depletion allowance is not based upon the taxpayer's cost or investment in the mineral deposit, but upon the revenues from mineral production; this allowance continues so long as income is received from production, even after the costs of acquiring and developing the mineral deposit have been fully recovered. 26 U.S.C. 613.

By permitting deductions that may be far in excess of the actual investment made to acquire and develop the mineral deposit, the percentage depletion allowance provides an unusual tax advantage to mineral producers. See *United States* v. *Swank*, 451 U.S. 571, 576-577 (1981). In 1969, concerned that high income taxpayers were succeeding in reducing, if not eliminating, their federal income tax liability through

extensive use of special allowances such as percentage depletion, Congress enacted a minimum tax on certain "items of tax preference." 26 U.S.C. 56 (1976). Congress classified the deduction for percentage depletion as a "tax preference" item (26 U.S.C. 57(a)(8) (1976)) and subjected the income sheltered by the deduction to the minimum tax.[3]

Under Section 57(a)(8), the amount of depletion that constitutes an item of tax preference for the taxable year is the excess of the depletion deduction for that year "over the adjusted basis of the property" at the end of that year. 26 U.S.C. 57(a)(8) (1976). The statute expressly provides (*ibid.*) that the term "property" in Section 57(a)(8) is to be given the same meaning afforded that term in Section 614 of the Code, 26 U.S.C. 614 (1976). In turn, Section 614 defines the term "property" as the taxpayer's interest in any specific "mineral deposit." *Ibid.*[4] Accordingly, it is the adjusted basis of the "mineral deposit" that must be subtracted from the

[3] During the years involved in this case, the minimum tax was 15% of the amount by which such items of "tax preference" exceeded certain deductions permitted under Section 56 of the Code. See 26 U.S.C. 56 (1976). Under Section 55 of the current provisions of the Code, items of "tax preference" are now included in the calculation of the "alternative minimum tax." 26 U.S.C. 55 (1988 & Supp. II 1990). This tax is assessed on "tax preference" items at the rate of 20% for corporations and 24% for other taxpayers. 26 U.S.C. 55(b)(1) (1988 & Supp. II 1990).

[4] 26 U.S.C. 614(a) provides:

> For the purpose of computing the depletion allowance in the case of mines, wells, and other natural deposits, the term "property" means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land.

depletion deduction to arrive at the amount of depletion that constitutes a tax preference item for any year. This calculation limits "tax preference" treatment to depletion deductions that exceed the basis, or cost, of the mineral deposit. It is only when deductions are permitted in excess of this cost basis that the ordinary economic principles embedded in the Code (that limit deductions from income to the amount necessary to recover the costs of producing that income) are violated. Percentage depletion deductions taken *before* taxpayers have fully recovered their investment in the "mineral deposit" are not treated as "tax preference" items under the Code. See 26 U.S.C. 57(a)(8), 614 (1976).

2. From their ownership of producing mineral deposits, respondents were entitled to percentage depletion deductions of $439,884 for 1981 and $371,636 for 1982 (Pet. App. 4a). In calculating the amounts of these depletion deductions that constituted an item of tax preference subject to the minimum tax, respondents asserted that the depletion allowance for each year should be reduced not only by the unrecovered costs of the mineral deposits (*i.e.*, the cost of acquiring ownership of the mineral deposits plus the intangible costs of drilling the wells),[5] but also by the unrecovered cost of the depreciable, tangible improvements to the mineral deposits (such as pipes, tools and other equipment having salvage value). Since respondents claimed unrecovered "tangible"

[5] Intangible drilling costs may be either deducted in the year incurred or added to the basis of the depletable mineral deposit. See 26 C.F.R. 1.612-1(b)(1), 1.612-4(a), (b)(1) and (b)(2). As is customary, respondents elected to deduct their intangible drilling costs fully in the year they were incurred (Pet. App. 5a). Respondents' basis in the mineral deposits involved in this case thus includes only the unrecovered costs of acquiring the deposit.

costs of $206,545 in 1981 and $131,216 in 1982 (*id.* at 25a), the addition of these costs to the adjusted basis of the mineral deposits substantially reduced respondents' "tax preference" income and, thereby, reduced their minimum tax (*id.* at 6a).

The Commissioner of Internal Revenue determined that respondents' depreciable tangible improvements are not part of their "mineral deposits" under Section 57 and that the unrecovered cost of such improvements is therefore not to be subtracted from respondents' depletion deductions in calculating the "tax preference" to which the minimum tax applies (Pet. App. 6a-7a).[6] As a result, the Commissioner issued a notice of deficiency to respondents for additional minimum taxes. Respondents paid the deficiencies and filed administrative refund claims. When the requested refunds were not granted, respondents filed this suit in the Claims Court.

[6] The parties' computations regarding the amounts of depletion subject to the minimum tax may be summarized as follows:

	Respondents		Government	
	1981	1982	1981	1982
Depletion allowable	$439,884	$371,636	$439,884	$371,636
Less: Unrecovered intangible costs (expensed)	—0—	—0—	—0—	—0—
Less: Unrecovered tangible costs	206,545	131,216	Disallowed	Disallowed
Depletion constituting a tax preference item	$233,339	$240,420	$439,884	$371,636

The tax deficiencies resulting from the government's calculations were $30,963 for 1981 and $18,733 for 1982. Pet. App. 2a; see C.A. App. 21-44.

3. On cross-motions for summary judgment, the Claims Court held that respondents were entitled to include the unrecovered costs of depreciable tangible improvements in the adjusted bases of their depletable mineral deposits in calculating the amount of depletion that constitutes an item of tax preference subject to the minimum tax (Pet. App. 2a-23a). The court acknowledged that "the Code establishes separate rules" for calculating deductions for depletion and for depreciation of improvements and that "the costs of depreciable improvements to the property are not a factor when calculating the amount of the depletion deduction" (*id.* at 9a). The court, therefore, "admitted[ ]" (*id.* at 10a) that comparing the depletion deduction only to *depletable* costs (rather than also to *depreciable* costs) "would create a symmetry of sorts because the unrecovered tangible costs are not a factor when calculating the depletion deduction in the first place" (*ibid.*). While the court recognized that "Congress clearly could have decided * * * that unrecovered tangible costs not be a part of the equation" in calculating the amount of depletion that constitutes a tax preference (*ibid.*), the court stated that Congress also *could* have chosen to reduce the amount of depletion treated as a tax preference item in order to advance the "aim of encouraging development of oil and gas reserves" (*ibid.*).

Finding no "clear indication" in the text or legislative history of the statute to guide its decision (Pet. App. 11a, 15a-17a n.10), the court relied on what it perceived to be the general principle that the word "property"—even as applied to a "mineral deposit" under Section 614—necessarily encompasses "improvements" to the property (Pet. App. 11a-23a). The court therefore held that Section 57(a)(8) requires that the unrecovered costs of depreciable tan-

gible improvements be included in the basis of the "mineral deposit" in determining the amount of depletion that constitutes a tax preference item.

4. The court of appeals affirmed and adopted the opinion of the Claims Court (Pet. App. 1a). In dissent, Chief Judge Nies observed that the term "property" incorporated by Section 57 from Section 614 refers specifically to the "*mineral deposit*" (Pet. App. 25a) and that the Claims Court's opinion neglected to take into account the established distinction between the terms "mineral deposit" and "mineral enterprise" (*id.* at 25a-26a, citing 26 C.F.R. 1.611-1(d)(3)). The term "mineral enterprise" has long been defined by regulations as the "mineral deposit" *plus* "improvements, if any, used in mining or in the production of oil and gas" (*ibid.*). The distinction drawn between "mineral deposit" and "mineral enterprise" is important because "only the mineral deposit itself is subject to a depletion allowance" (Pet. App. 26a). The Chief Judge noted (*ibid.*, citing 26 C.F.R. 1.611-2(b)(1)) that a separate capital account must be maintained for each mineral deposit:

> The capital account of the mineral deposit on which depletion is calculated includes the cost of the deposit itself and certain * * * specific adjustments. It does not include the cost of improvements used in production, such as machinery and pipes.

Under the majority's holding, however, tangible costs that are not part of the basis of the "mineral deposit" (but instead form part of the basis of the "mineral enterprise") "may be transferred over to the mineral deposit so as to reduce the minimum tax" (Pet. App. 26a). Chief Judge Nies concluded that "a straight forward as well as logical reading of the

statute" compels rejection of the claim that Congress intended to include the costs of depreciable improvements in the basis of the taxpayers' depletable "mineral deposit" (*id.* at 26a-27a):

> [I]nasmuch as only the deposits themselves are the "property" depletable under section 611, it is solely the adjusted basis of that "property" which must be deducted from the depletion allowance to arrive at the excess of depletion subject to the minimum tax.

SUMMARY OF ARGUMENT

From its inception, the allowance for percentage depletion has conferred an unusual tax benefit on mineral producers. Under the Internal Revenue Code, deductions for business activities are ordinarily based on the economic principle that a taxpayer is entitled to a tax-free recovery of the costs of conducting the business. This principle is recognized by the current deduction for ordinary business expenses (26 U.S.C 162) and by the annual depreciation deduction for capital equipment (26 U.S.C. 167). These deductions end when the costs involved have been fully recovered. The percentage depletion deduction, however, is not based on the cost of producing minerals; instead, it is based on the income received from mineral production. A taxpayer may continue to claim percentage depletion deductions so long as production continues, even after he has fully recovered his investment in the mineral property. It is the potential economic unfairness resulting from this special tax benefit for mineral producers that Congress sought to limit by designating percentage depletion as a "tax preference" subject to the minimum tax under Sections 56 and 57 of the Internal Revenue Code.

The issue presented by this case involves the proper computation of the amount of the allowable depletion that constitutes a "tax preference." Section 57(a)(8) of the Code, by incorporating Section 614, provides that a depletion allowance that exceeds the "adjusted basis" of a "mineral deposit" is a tax preference. 26 U.S.C. 57(a)(8) (1976). It is only the portion of the depletion allowance that exceeds the taxpayer's adjusted basis in the mineral deposit that conflicts with the ordinary cost-recovery principles of the Code; it is thus only that excess that is treated as a "tax preference" under the Code.

The dispute in this case centers on calculation of the "adjusted basis" of the mineral deposit in determining the amount of the depletion "tax preference." The courts below concluded that the unrecovered costs of *depreciable* machinery and other tangible equipment used in mineral production are to be added to the adjusted basis of the *depletable* mineral deposit in making the calculation required by Section 57(a)(8). The courts admitted (Pet. App. 9a) that the costs of depreciable improvements are not a factor when calculating the amount of the depletion deduction itself, but they concluded that the machinery and equipment constitute "improvements" to the mineral property and, for that reason, are to be added to the basis of the mineral deposit in determining the minimum tax.

That conclusion is incorrect. The unrecovered costs of *depreciable* tangible improvements are not to be added to the adjusted basis of the depletable mineral deposit in calculating the amount of depletion that constitutes a tax preference subject to the minimum tax. The crux of the courts' error is the failure to recognize that a *depletable* mineral deposit and the *depreciable* improvements to that deposit are *separate* properties, each with its own separate capital account.

They are treated separately, with separate bases, precisely because they are subject to different methods of cost-recovery. While the machinery and equipment used in mineral production represent tangible "improvements" to the mineral deposit, the cost of such improvements does not form part of the basis of the mineral deposit and is therefore not to be considered in calculating the depletion "tax preference" under Section 57(a)(8).

Including the unrecovered costs of *depreciable* improvements in the adjusted basis of the *depletable* mineral deposit would permit depletion deductions in excess of the actual costs of the mineral deposit to escape recapture and taxation under the provisions of the minimum tax. By entrenching the unfairness that Congress sought to curtail in enacting the minimum tax, the decision of the court of appeals disregards the plain language and thwarts the clear purpose of the statute.

ARGUMENT

THE UNRECOVERED COSTS OF DEPRECIABLE TANGIBLE IMPROVEMENTS TO A MINERAL DEPOSIT ARE NOT INCLUDED IN THE ADJUSTED BASIS OF THE MINERAL DEPOSIT IN DETERMINING THE AMOUNT OF DEPLETION THAT CONSTITUTES AN ITEM OF TAX PREFERENCE SUBJECT TO THE MINIMUM TAX UNDER SECTION 57(a)(8) OF THE INTERNAL REVENUE CODE

This case involves the text and history not only of the minimum tax provisions of Sections 56 and 57 of the Internal Revenue Code, but also of the mineral depletion provisions of Sections 611 through 614 of the Code. From their inception, the depletion provisions have differentiated between mineral deposits—the costs of which are recovered through the deple-

tion allowance—and tangible "improvements" used to extract the minerals—the costs of which are recovered through depreciation. While depreciation deductions may not be taken after the taxpayer has fully recovered his cost basis in the improvement, percentage depletion deductions may continue to be taken long after the taxpayer's cost or investment in the mineral deposit has been recovered. It is the special tax benefit that percentage depletion provides for mineral producers that Congress sought to limit, and partially "recapture," by making it an "item of tax preference" subject to the minimum tax under Sections 56 and 57 of the Code.

A. The Minimum Tax On "Items Of Tax Preference" Is Designed To Limit The Economic Unfairness Of Preferential Code Provisions

Since 1969, Congress has expressed concern that various tax preferences under the Internal Revenue Code permit "individuals and corporations to escape tax on certain portions of their economic income," which results "in an unfair distribution of the tax burden." S. Rep. No. 552, 91st Cong., 1st Sess. 112 (1969). The potentially unfair preferences that Congress has identified are of two general types: (i) provisions that shield various types of income from tax (*e.g.*, capital gains, tax-exempt interest and mineral depletion deductions) and (ii) provisions that permit accelerated recovery of investment costs at rates in advance of the actual consumption or exhaustion of the property involved (*e.g.*, accelerated depreciation, current deduction of intangible drilling expenses). See 26 U.S.C. 57(a) (1976); 26 U.S.C. 57(a) (1988 & Supp. II 1990); S. Rep. No. 938, 94th Cong., 2d Sess. 109 (1976). The "minimum tax" provisions of Sections 56 and 57 of the Code were

enacted in 1969 to limit abusive use of such tax preferences (S. Rep. No. 938, *supra*, at 109):

> The existing minimum tax on tax preferences was enacted in 1969 in order to ensure that high-income individuals and corporations pay at least a minimum tax on their tax preferences, including both exclusions from taxable income and deferrals of tax liability into future tax years.

The purpose of the minimum tax is to "make sure that the aggregating of tax-preference items does not result in the taxpayer's paying a shockingly low percentage of his income as tax." *First Chicago Corp.* v. *Commissioner*, 842 F.2d 180, 181 (7th Cir. 1988).[7] As it applies in the years relevant to this case,[8] the

[7] The minimum tax is designed to ensure "that at least some minimum tax was paid on tax preference items, especially in the case of high-income persons who were not paying their fair share of income taxes." H.R. Rep. No. 658, 94th Cong., 1st Sess. 130 (1975). See also H.R. Conf. Rep. No. 782, 91st Cong., 1st Sess. 658 (1969).

[8] In 1978, Congress restructured the minimum tax by creating an alternative minimum tax (in addition to the minimum tax) applicable only to non-corporate taxpayers. Revenue Act of 1978, Pub. L. No. 95-600, § 421, 92 Stat. 2871-2874. The alternative minimum tax formula, contained in new Section 55 of the Code, differed from the minimum tax in that the amount of alternative minimum tax calculated to be due was not simply added to the amount of income tax due, as was the case with the minimum tax. Instead, if the alternative minimum tax was greater than the tax liability determined under the normal provisions (including the minimum tax), then the taxpayer's tax liability was the amount calculated under the alternative minimum tax provisions (although, as a technical matter, the statute required the taxpayer to pay the amount by which the alternative minimum tax exceeded the normal tax liability as an addition to the

statute imposes, in addition to the regular income tax, a tax of 15 percent of the amount by which the sum of the enumerated tax preference items in Section 57(a) exceeds the specific deductions permitted by Section 56 of the Code. See 26 U.S.C. 56, 57(a) (1976).[9]

normal tax). The alternative minimum tax is imposed at a graduated rate upon "alternative minimum taxable income," which is essentially the taxpayer's taxable income, increased by the amount of his long-term capital gains deduction and his adjusted itemized deductions.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, § 201, 96 Stat. 423, made further sweeping changes, repealing the minimum tax for non-corporate taxpayers. It also reformulated the alternative minimum tax applicable to them, including items of tax preference in the calculation of alternative minimum taxable income. TEFRA did not displace the minimum tax for corporations.

The alternative minimum tax was again substantially revised for years beginning after 1986. Tax Reform Act of 1986, Pub. L. No. 99-514, § 701, 100 Stat. 2320-2335. The 1986 Act repealed the minimum tax for corporations and made the alternative minimum tax applicable to corporations. Section 57(a)(8) was redesignated as Section 57(a)(1) as part of the 1986 amendments, and percentage depletion thus remains an item of tax preference. Under Section 55 of the current provisions of the Code, tax preference items are now included in the calculation of the alternative minimum tax. 26 U.S.C. 55. The tax imposed is 20% for corporations and 24% for other taxpayers of the excess of the tentative minimum tax over the regular tax for the year. 26 U.S.C. 55 (1988 & Supp. II 1990).

[9] Some of the tax preferences that existed in 1969 have since been abolished by amendments to the Code. Other new items (*e.g.*, tax exempt interest) have been added to the list of "items of tax preference" in Section 57. Compare 26 U.S.C. 57(a)(1)-(11) (1976) with 26 U.S.C. 57(a)(1)-(7) (1988 & Supp II 1990).

B. Depletion Allowances In Excess Of The Adjusted Basis Of The Mineral Deposit Constitute A Tax Preference

From the first enactment of the minimum tax, Congress has classified the mineral depletion allowance as an "item of tax preference" and subjected the income sheltered by this deduction to the minimum tax. 26 U.S.C. 56, 57(a)(8) (1976). Whereas business-related deductions are ordinarily based on the economic principle that the taxpayer should be allowed a tax-free recovery of the costs of conducting a business (see 26 U.S.C. 162, 167), the percentage depletion allowance is not based on the costs of the mineral operation but on the revenues derived from it. Unlike cost-recovery deductions, which terminate once business costs have been recovered, the percentage depletion deduction continues so long as mineral production continues, even after the depletable costs have been fully recovered.

To limit the unfairness of the depletion deduction, Section 57(a)(8) thus provides that the amount of the depletion allowance that constitutes a "tax preference" for any year is the excess of the depletion deduction taken in that year over the "adjusted basis" of the mineral "property." 26 U.S.C. 57(a)(8) (1976). The term "property" is defined for this purpose by reference to Section 614 of the Code. See 26 U.S.C. 57(a)(8) (1976). Section 614, in turn, provides that the term "property" means the "mineral deposit" in which the taxpayer owns an interest. 26 U.S.C. 614 (1976). Reading these provisions together, a depletion allowance constitutes a "tax preference" under Section 57 to the extent that the depletion deduction exceeds the taxpayer's adjusted basis in the "mineral deposit."

The term "mineral deposit" refers to the minerals in place. 26 C.F.R. 1.611-1(d)(4). Section 611 of the Code differentiates in the treatment of mineral deposits (the costs of which are recovered by "a reasonable allowance for depletion" (26 U.S.C. 611)) and tangible "improvements" used to extract the minerals from the deposit (the costs of which are recovered by a deduction for "depreciation of improvements" (*ibid.*)). It is only the allowance for depletion, not the ordinary deduction for "depreciation of improvements," that constitutes an item of "tax preference" under Section 57(a)(8).

1. *Depreciation of "Improvements."* The depreciation deduction for "improvements" to a mineral deposit provided by Section 611 is governed by the general provisions of Section 167 of the Code, 26 U.S.C. 167.[10] This provision permits an annual allowance for the exhaustion of machinery, tools and other such tangible equipment over their reasonable useful lives. See *ibid.;* 26 C.F.R. 1.611-5(a). The allowance for depreciation of tangible "improvements" to a mineral deposit is based upon the costs that the taxpayer incurs to acquire the improvements. The taxpayer is required to maintain a separate capital account for each improvement (26 C.F.R. 1.167(a)-7; 26 C.F.R. 1.611-5(c)) and, once the cost of the improvement is fully recovered through annual depreciation, no additional deductions are allowed. See 26 U.S.C. 167(g), 1011, 1012, 1016(a)(2). The ordinary depreciation of "improvements" to a mineral deposit is based on the cost-recovery principles generally applicable to business deductions under the Code and thus creates no tax preference of the type Congress identified in Section 57(a)(8).[11]

[10] Section 167 provides "as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)" of property "used in the trade or business" or "held for the production of income." 26 U.S.C. 167(a).

2. *Depletion Allowance for the Mineral Deposit.* The separate allowance provided by Section 611 for depletion of the "mineral deposit" is, however, quite different. In determining the "reasonable allowance for depletion" of the mineral deposit, the taxpayer may elect either "cost depletion" or "percentage depletion," whichever is more favorable to the taxpayer. 26 U.S.C. 612, 613; 26 C.F.R. 1.611-1(a)(1).

(a) *Cost Depletion of the Mineral Deposit.* Cost depletion permits the taxpayer to deduct the part of his cost basis in the mineral deposit that is allocable to the minerals extracted during the taxable year. 26 U.S.C. 612; 26 C.F.R. 1.611-2(a).[12] In determining

[11] Congress has, from time to time, adopted various accelerated depreciation provisions. See, *e.g.*, 26 U.S.C. 168 (1982). When accelerated depreciation has been allowed, Congress has typically included the spread between accelerated and straight-line depreciation allowances as a "tax preference" item. See 26 U.S.C. 57(a)(2) and (3) (1976); 26 U.S.C. 57(a)(12) (1982). Accelerated depreciation is a "tax preference" because it defers "tax liability into future years" (S. Rep. No. 938, *supra*, at 109). By contrast, the depletion allowance is a "tax preference" because it results in "exclusions [of mining revenues] from taxable income" (*ibid.*). The fact that Congress has dealt separately with these two different types of tax preference items underscores the illogic of combining the costs of depreciable improvements with the costs of depletable mineral deposits in calculating the preference resulting from depletion under Section 57(a)(8).

[12] Cost depletion is a method for recovering the capitalized costs of the mineral deposit. The basis of the mineral deposit may include, in addition to the costs of acquiring the deposit, any capitalized intangible drilling costs if the taxpayer elects

the basis of the mineral deposit for application of this provision, Treasury regulations explicitly provide that "[t]he basis for cost depletion of mineral * * * property does not include * * * [a]mounts recoverable through depreciation deductions" (26 C.F.R. 1.612-1(b)(1)(i)).[13]

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to capitalize, rather than deduct currently, those costs. See 26 C.F.R. 1.612-1(b)(1), 1.612-4(b)(1). Section 263(c) of the Code allows mineral operators to deduct intangible drilling costs currently, rather than capitalizing them. See 26 U.S.C. 263(c). As is customary, respondents elected to deduct their intangible drilling costs currently and the capital accounts for their mineral deposits thus include none of these costs. See note 5, *supra*.

By permitting current deductions for intangible drilling costs incurred in drilling a well that may be productive for many years, the Code provides a "tax preference" for this type of expense. This preference is analogous to the preference created by accelerated depreciation. See note 11, *supra*; S. Rep. No. 938, *supra*, at 111 ("accelerated intangible drilling expenses are those in excess of expenses which could have been deducted had the intangibles been capitalized and either deducted over the life of the well as cost depletion * * * or deducted ratably over ten years"). In 1976, Congress therefore included the current deduction for intangible drilling costs as an "item of tax preference" subject to the minimum tax. See 26 U.S.C. 57(a)(11) (1976); 26 U.S.C. 57(a)(2) (1988 & Supp. II 1990).

The application of the tax preference for intangible drilling costs is not directly at issue in this case. As with the preference for accelerated depreciation, however, the fact that Congress dealt separately with the various cost components of a mining operation in defining separate "tax preference" items further reflects the illogic of combining non-depletable costs in the basis of the depletable mineral deposit in calculating the depletion tax preference under Section 57(a)(8).

[13] The court of appeals stated that this regulation has no relevance to this case because the regulation pertains only to the computation of basis for cost depletion, while this case

The effect of cost depletion is similar to depreciation, in that it spreads the recovery of capital costs over the expected useful life of the investment. Like depreciation deductions, cost depletion deductions reduce the basis of the property with respect to which they are taken, and cost depletion provides no deductions once the adjusted basis of the mineral deposit has been fully recovered (26 C.F.R. 1.611-2(b)(2)). The taxpayer must maintain a separate capital account for each depletable mineral deposit, just as he must for each depreciable tangible improvement to the mineral deposit. See 26 C.F.R. 1.611-2(b), 1.611-5(c).[14] Once the capital invested is fully re-

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involves percentage depletion (Pet. App. 21a). The court failed to recognize that the basis of a mineral property is calculated in the same manner regardless whether cost or percentage depletion is used. See 26 C.F.R. 1.611-2(b). Since the taxpayer is to use whichever method provides the greater deduction (26 C.F.R. 1.611-1(a)(1)), this determination of the taxpayer's basis must be made each year. The regulations covering percentage depletion under Section 613 do not specifically address basis—as Section 1.612-1(b) does with respect to cost depletion—because basis is not relevant in computing percentage depletion. Percentage depletion allowances may be taken even though the property's entire basis has been recovered. See 26 C.F.R. 1.611-2(b)(2).

[14] Section 1.611-2(b)(1) of the Regulations, 26 C.F.R. 1.611-2(b)(1), requires "[e]very taxpayer claiming and making a deduction for depletion of mineral property [to] keep a separate account in which shall be accurately recorded the cost or other basis provided by section 1012, of such property together with subsequent allowable capital additions to each account and all the other adjustments required by section 1016." Section 1.611-2(b)(2), 26 C.F.R. 1.611-2(b)(2), in turn, provides that a mineral property account shall be credited annually with the amounts of the depletion computed in accordance with Section 611 or 613, and their accompany-

covered, no additional cost depletion deductions are allowed. As with the ordinary depreciation of improvements, the cost depletion deduction is thus consistent with the cost-recovery principles of the Code and creates no tax preference of the type Congress identified in Section 57.

(b) *Percentage Depletion of the Mineral Deposit.* In marked contrast to the "depreciation of improvements" (26 U.S.C. 611) and the "cost depletion" of a mineral deposit (26 U.S.C. 612), the allowance for percentage depletion is completely *unrelated* to the amount of a taxpayer's investment in a mineral property. The allowance for percentage depletion is computed as a specified percentage of the gross income derived from the extraction of minerals from the mineral deposit during the taxable year. 26 U.S.C. 613, 613A. Because it is based on gross income, rather than on cost, this allowance continues so long as minerals are extracted and revenues are received, even if the costs of acquiring and developing the mineral deposit have already been fully recovered. 26 U.S.C. 613, 613A; 26 C.F.R. 1.611-2(b)(2). See generally 5 J. Mertens, *Law of Federal Income Taxation* ¶ 24.60 (1991). The percentage depletion allowance thereby provides a special and unusual tax advantage to mineral producers. See *United States* v. *Swank*, 451 U.S. 571, 576-577 (1981). As Justice Stewart noted in his dissent in *United States* v. *Skelly Oil Co.*, 394 U.S. 678 (1969), the percentage depletion allowance may be "the most generous business deduction in the Code." *Id.* at 692 n.2.

ing regulations. Section 1.611-5(c) of the Regulations (26 C.F.R. 1.611-5(c)) incorporates by reference the provision of Section 1.167(a)-7 (26 C.F.R. 1.167(a)-7) that each depreciable improvement is to be treated under a separate capital account.

By permitting deductions that may be far in excess of the actual investment made to acquire and develop the mineral deposit, the percentage depletion allowance conflicts with the ordinary economic cost-recovery principles of the Code. It is for this reason that Congress identified the "tax preference" associated with the depletion allowance as the amount of the depletion deduction that exceeds the taxpayer's adjusted basis in the "mineral deposit" (26 U.S.C. 58(a)(8) (1976), incorporating 26 U.S.C. 614). Once the taxpayer's cost basis in the "mineral deposit" has been recovered, the excess depletion deductions constitute a "tax preference."

C. The Costs Of Depreciable Tangible "Improvements" Are Not Included In The Basis Of A "Mineral Deposit"

The courts below erred in concluding (Pet. App. 1a, 7a-22a) that, in calculating the amount of the depletion "tax preference," the adjusted basis of the "mineral deposit" should include not only the costs of acquiring the mineral deposit but also the costs of tangible equipment that constitutes an "improvement" to the deposit.

1. The courts below correctly noted (Pet. App. 7a-9a) that the adjusted basis of a property generally includes "the costs of improvements and betterments to a property" (26 C.F.R. 1.1016-2(a)) when those expenditures are "properly chargeable to the capital account" (26 U.S.C. 1016(a)(1)). Because Section 611 provides different cost-recovery methods for "depletion" of a mineral deposit and for "depreciation of improvements" (26 U.S.C. 611; see pages 16-21, *supra*), however, the tangible "improvements" to a mineral deposit are accounted for separately from the mineral deposit itself and are *not* "properly chargeable to the capital account" of the mineral deposit.

The distinction in the treatment of depletable mineral deposits and depreciable improvements under Section 611 is implemented by regulations requiring that a separate capital account be maintained for the "mineral deposit" and for each tangible "improvement[]" to the deposit (see 26 C.F.R. 1.167(a)-7; 26 C.F.R. 1.611-2(b)(1), 1.611-5(c)). See pages 18-19, *supra*. This separate treatment of the depletable and depreciable accounts is reinforced by regulations mandating that the basis of depletable mineral deposits "*does not include* * * * [a]mounts recoverable through depreciation deductions" (26 C.F.R. 1.612-1(b)(1) (emphasis added)). See note 13, *supra*. The different and separate treatment of mineral deposits and improvements is further recognized and implemented by the long-standing regulatory distinction between a "mineral deposit" and a "mineral enterprise," which consists of the "mineral deposit or deposits and improvements" (26 C.F.R. 1.611-1(d)(3)).[15] These regulatory provisions requiring separate capital accounts for depletable "mineral deposits" and for depreciable "improvements" are necessary to implement the sep-

[15] Treasury regulations distinguish between the terms "mineral deposit" and "mineral enterprise" for the purpose of assigning a separate cost basis to the depletable mineral deposit and to the associated improvements when, as is customary, a mineral enterprise is acquired as a unit. In such instances, "the cost of any interest in the mineral deposit or deposits is that proportion of the total cost of the mineral enterprise which the value of the interest in the deposit or deposits bears to the value of the entire enterprise at the time of its acquisition." 26 C.F.R. 1.611-1(d)(4). A similar allocation of basis with respect to depreciable property is required when depreciable and non-depreciable property is acquired for a lump sum. 26 C.F.R. 1.167(a)-5. See Rev. Rul. 69-539, 69-2 C.B. 141.

arate cost-recovery methodologies applied to such costs under Section 611. The distinct treatment of these categories of costs, and the separate capital accounts maintained for each, were in place long before Section 57(a)(8) was enacted.

In enacting Section 57(a)(8), Congress legislated against the background of this clear historical distinction. If Congress had intended the result adopted by the courts below, Section 57(a)(8) would have referred not to the adjusted basis of the "mineral deposit" but to the unrecovered costs of the "mineral enterprise." By adhering to the long-standing distinctions drawn between the separate capital accounts maintained for the depletable mineral deposit and for depreciable tangible "improvements," Congress properly focused the tax preference calculation directly upon the area of its concern. For, as we have explained (pages 16-21, *supra*), it is excess depletion of mineral deposits, *not* the ordinary "depreciation of improvements" (26 U.S.C. 611), that makes the depletion allowance potentially unfair and subject to economic abuse.

As the courts below recognized, "[b]y referencing the Section 614 definition of property, Section 57 (a)(8) clearly envisions application of the *same* rules for tax preference purposes and envisions calculating the item of tax preference based on the same 'property' for which the depletion deduction was calculated in the first place" (Pet. App. 14a; emphasis added). Although depreciable equipment and machinery are "improvements" to a mineral deposit, such depreciable assets have their own capital accounts and are not properly chargeable to the capital account of the depletable mineral deposit. 26 C.F.R. 1.167(a)-7, 1.611-5, 1.612-1(b)(1)(i), 1.612-4(b)(2) and (c). See also *Parsons* v. *Smith*, 359 U.S.

215, 225 (1959) (investments in equipment are "recoverable through depreciation—not depletion"); *Holbrook* v. *Commissioner*, 65 T.C. 415, 520 (1975) (improvements consisting of depreciable equipment do not constitute capital investments in minerals in place).[16] For this reason, the unrecovered cost of *depreciable* improvements is excluded from the adjusted basis of a taxpayer's *depletable* mineral properties. See *Mobley* v. *United States*, 8 Cl. Ct. 767, 771 (1985) (under the "clear language of [Section 57(a)(8)], the minimum tax, as applied to percentage depletion, * * * operates to tax income otherwise sheltered by plaintiffs' depletion deductions which are in excess of their basis in the *depletable* property" (emphasis added)). See also notes 11, 12, *supra*.

The court of appeals failed to recognize that depletable mineral deposits and depreciable tangible improvements are *separate* properties with *separate* capital accounts. Although tangible "improvements" to a "mineral deposit" may be properly includable in the basis of the "mineral enterprise" for the purpose of determining gain on sale of the mineral enterprise as a unit (see note 19, *infra*), those depreciable "improvements" have their own capital accounts, separate and distinct from the capital account

[16] Tangible improvements to a mineral deposit, such as machinery and equipment, may be compared to a new parking garage constructed adjacent to a shopping center. The garage and the mining equipment respectively "improve" the shopping center and the mineral property; indeed, both the parking garage in the one case and the mining equipment in the other may be thought to be necessary to the conduct of the respective businesses. But the cost of the parking garage is not included in the adjusted basis of the shopping center under Section 1016 of the Code because it is a separate depreciable asset with its own capital account.

of each depletable mineral deposit that is a component part of the mineral enterprise. The cost of depreciable tangible improvements is not "properly chargeable" to the capital account of the depletable mineral deposit and is therefore not to be considered in calculating the tax preference resulting from excess depletion deductions under Section 57(a)(8).

2. Failing to recognize the distinction drawn by the statute between a depletable "mineral deposit" and depreciable "improvements," the courts below chose to rely upon the broad assertion that it "is conceivable" that Congress desired to deduct unrecovered, *depreciable* tangible costs from the calculation of the *depletion* tax preference to provide "incentives to encourage oil and gas exploration and development" (Pet. App. 10a). While many things may be "conceivable," it seems clear that depletion was not designated as an item of "tax preference," and subjected to the minimum tax, in order to provide an "incentive" for mining activity or otherwise promote unfairness in the tax system. The legislative history of Section 57(a)(8) strongly refutes that contention.

In its original consideration of Section 57(a)(8), the only mining costs addressed by Congress as forming part of the adjusted basis of the mineral deposit under Section 57(a)(8) were (i) the costs of acquiring the mineral deposit and (ii) the capitalized intangible drilling costs that are also subject to the percentage depletion allowance (see note 12, *supra*). See S. Rep. No. 552, *supra*, at 114, 115. This history reflects that the adjusted basis of the mineral deposit referred to in Section 57(a)(8) includes only *depletable* costs and does not include the costs of *depreciable* improvements that are not subject to percentage depletion.

Congress reemphasized this evident intent in 1986 when, in the course of revising and reenacting the Internal Revenue Code, Congress revised Section 57 and redesignated Section 57(a)(8) as 57(a)(1). See note 2, *supra*. The Conference Committee Report on the 1986 Act noted that the new provision merely reenacted the prior law. H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. Pt. 2, at 254 (1986). The Report then stated in clear and simple terms how the "tax preference" calculation for percentage depletion is to made under this statute (*ibid.*) (emphasis added):

> The excess over the adjusted basis of the *depletable property* is a preference.

See also 4 B. Bittker & L. Lokken, *Federal Taxation of Income Estates and Gifts* ¶ 111.4.2, at 111-98 (2d ed. 1992) (the tax preference is the "excess of the depletion deduction over the taxpayer's adjusted basis for the *depletable* property") (emphasis added).

The courts below, however, reached the diametrically opposite conclusion that the basis of both depletable *and* depreciable property is to be considered in determining the amount of the tax preference resulting from depletion. The decision in this case thus conflicts with the clear and direct congressional description of the proper operation of the statute.

3. The lower courts erroneously stated (Pet. App. 15a) that the exclusion of depreciable tangible improvements from the basis of a depletable mineral deposit is inconsistent with the treatment accorded the cost of intangible drilling costs, which (if not expensed currently, see notes 5, 12, *supra*) are included in the basis of the mineral deposit.[17] Nearly

[17] Intangible drilling costs (*e.g.*, amounts paid for labor, fuels, repairs, hauling, and supplies used in the drilling of

60 years ago, however, looking to the history of the legislation governing mineral depletion and the administrative practice under it, this Court rejected the similar contention that there was no logical basis for distinguishing between tangible and intangible improvements to mineral deposits with respect to the recovery of their cost through the separate methods of depletion and depreciation. See *United States* v. *Dakota-Montana Oil Co.*, 288 U.S. 459 (1933). The taxpayer in that case sought to depreciate its capitalized intangible development costs. The government took the position that the proper deduction was for depletion, not depreciation, and was therefore already accounted for in the taxpayer's percentage depletion allowance. The government noted that the intangible expenses of drilling a well do not create a tangible property that wears out with use or has a salvage value (*id.* at 462). As a result, the intangible costs of drilling the well are to be treated either as a part of the cost, or an addition to the value, of the oil in the ground (*id.* at 466). In holding for the government, the Court observed that the Treasury had long (*id.* at 465)

> made explicit * * * that development costs other than the cost of physical property incident to the development must be returned through the de-

wells or in the preparation for drilling) may be either deducted currently or capitalized. 26 U.S.C. 263(c); 26 C.F.R. 1.612-4(a). If the taxpayer elects to capitalize such expenditures, they are recoverable through depreciation only to the extent they are represented by physical property (26 C.F.R. 1.612-4(b)(2)); otherwise, they are recoverable through depletion (26 C.F.R. 1.612-4(b)(1)). Costs recoverable through depletion are properly chargeable to the capital account of the mineral property, but any costs recoverable through depreciation are not. 26 C.F.R. 1.612-1(b)(1).

> pletion allowance, but the regulations also provided expressly that the cost of "physical property such as machinery, tools, equipment, pipes, etc.," should be returned by an annual allowance for depreciation.

The Court further noted that this distinction between depletable and depreciable costs was adopted by Congress and continued under subsequent revenue Acts. *Ibid.* See also 26 U.S.C. 611. The regulations currently in effect have maintained this same distinction. See 26 C.F.R. 1.612-4(a) and (b).

The separate treatment of depletable intangible drilling costs and depreciable tangible improvements does not reflect an inconsistency. Instead, it reflects an economic reality concerning mining operations. Intangible drilling costs enhance the value of the mineral deposit but lack any definable useful life or other characteristics of depreciable tangible improvements. These intangible costs are therefore subject to the depletion allowance rather than depreciation. *United States* v. *Dakota-Montana Oil Co.*, 288 U.S. at 465-466. This economic reality is one of which Congress has long been aware (*ibid.*), and for which Treasury regulations have long provided (26 C.F.R. 1.612-4(a) and (b)).

4. The conclusion of the courts below that the unrecovered cost of depreciable tangible improvements should be set off against the depletion allowance in calculating the amount of the tax preference item under Section 57(a)(8) is fundamentally illogical. There is no valid basis to conclude that costs ultimately to be recovered through *depreciation* may properly be set off against the depletion allowance for the purpose of determining whether the taxpayer has received depletion deductions in excess of the basis of the depletable mineral deposit. Such a conclusion would require the assumption that Congress meant to enact a strange and self-defeating scheme in which apples (the amount of excess depletion) are compared with oranges (the basis of depreciable property) in calculating the amount of the depletion tax preference under Section 57(a)(8), 26 U.S.C. 57(a)(8) (1976). As Chief Judge Nies correctly stated in dissent, there is "no reason, in logic or in the statute and regulations, why costs of capital improvements, which have nothing to do with the calculation of depletion under section 611 of the Code, should be added to the adjusted basis of the oil and gas deposits for purposes of reducing the alternative minimum tax" (Pet. App. 26a).

The incongruity of the courts' interpretation of the statute is emphasized by the fact that, under the lower courts' view, the taxpayer is allowed to set off the unrecovered balance of depreciable costs *each year*, even when the depletion allowance in the prior years far exceeds the taxpayer's basis both in its depletable *and* depreciable property (see note 6, *supra*). The purpose of the minimum tax is to capture and tax, even if at a reduced rate, the special allowances that create preferential income under the Code and that "impair the equity of the tax system" (S. Rep. No. 938, *supra*, at 109). That purpose is frustrated and impeded by the decision in this case.[18]

The fiscal consequences resulting from the interpretation of Section 57 adopted by the courts below

---

[18] As this Court noted in *Watt* v. *Alaska*, 451 U.S. 259 (1981), "statutes always have some purpose or object to accomplish, whose sympathetic and imaginative discovery is the surest guide to their meaning." *Id.* at 266 n.9 (quoting *Cabell* v. *Markham*, 148 F.2d 737, 739 (2d Cir.) (L. Hand, J.), aff'd, 326 U.S. 404 (1945)).

are enormous. The Internal Revenue Service advises that, for the period from 1985 to 1989 alone, more than $5 billion of revenue from the minimum tax on tax preference items is affected by this decision.[19] This startling economic effect was evidently not anticipated by the tax bar;[20] since the date of the decision, the IRS has received a steady stream of new refund claims (already aggregating in excess of $500,000,000) that seek to benefit from the surprising decision in this case.

While it is not possible to place a definite upper limit on the ultimate revenue effect of the lower courts' holding, the revenue losses clearly would be substantial. Moreover, these revenue losses would occur in the precise economic arena that Congress specifically determined was benefitting too greatly from the preferences granted under the Internal Revenue Code. By entrenching the same "unfair distribution of the tax burden" that Congress sought to curtail (S. Rep. No. 552, *supra*, at 112), the courts below have reached a result that can not be reconciled with the language, the history or the purpose of the statute.

[19] The fiscal effects of the lower courts' decision may be even greater than the Service predicts if the same analysis is applied not only to the oil and gas and hard mineral industries under Section 57 but also to the special rules applicable to the depletion allowance for the coal and iron ore industries under the parallel language of Section 291(a)(2)(B) of the Code. Section 291 reduces by 20% the depletion allowance available for these industries when the allowance, as computed under Section 613, exceeds the adjusted basis of the "property." 26 U.S.C. 291(a)(2)(B). If the analysis of the statutory language applied by the courts below in this case were applied also to Section 291, a substantial increase in the depletion allowance available to these industries would result.

[20] Scholarly critiques of the Federal Circuit's decision have also expressed strong disagreement with its conclusions. See Dzienkowski & Peroni, *A Critical View of the* Hill *Decisions: Calculating Excess Depletion Under the Alternative Minimum Tax*, 28 The Nat. Res. Tax Rev. 243 (Sept.-Oct. 1991); M. McMahon, Jr., *Significant Current Developments in Oil and Gas Taxation*, 42d Ann. Inst. on Oil & Gas & Taxation § 15.10[2], at 15-53 (S.W. Legal Foundation 1991) ("The court's analysis is alluring, but incorrect.").

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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No. 91-1421

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1992

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Petitioner,

v.

WILLIAM F. HILL and LOLA E. HILL,
Respondents.

ON WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

BRIEF FOR THE RESPONDENTS

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QUESTION PRESENTED

Whether the unrecovered cost of depreciable (tangible) improvements to an oil and gas property may properly be included in the adjusted basis of the property (as defined in section 614), for purposes of determining the amount of the depletion deduction that constitutes a tax preference item subject to the minimum tax under section 57(a)(8) of the Internal Revenue Code.

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IN THE

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FOR THE FEDERAL CIRCUIT

BRIEF FOR THE RESPONDENTS

STATUTES AND REGULATIONS INVOLVED

1. Section 57 of the Internal Revenue Code,[1] 26U.S.C. 57 provides in relevant part:

> (a) *In General.* – For purposes of this part, the items of tax preference are –
>
> (8) *Depletion.* – With respect to each property (as defined in section 614), the excess of the deduc-

[1] All references to "IRC", "Code", "Internal Revenue Code" or "section" in this Brief mean Title 26, U.S.C., the Internal Revenue Code of 1954, as amended to the tax years at issue.

tion for depletion allowable under section 611 for the taxable year over the *adjusted basis* of the property at the end of the taxable year (determined without regard to the depletion deduction for the taxable year). (Emphasis added).

2. Section 1.57-1(h)(3) of the Treasury Regulations,[2] 26 C.F.R. 1.57-1(h)(3):

(3) *Adjusted Basis.* For the determination of the adjusted basis of the property at the end of the taxable year *see section 1016 and the regulations thereunder.* (Emphasis added).

3. Section 1.1016-1 of the Treasury Regulations, 26 C.F.R. 1.1016-1 provides in relevant part:

Section 1016 and §§1.1016-2 to 1.1016-10, inclusive, contain the rules relating to the adjustments to be made to basis of the property to determine the adjusted basis as defined in Section 1011.

4. Section 1.1016-2(a) of the Treasury Regulations, 26 C.F.R. 1.1016-2(a):

(a) The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, *including the cost of improvements and betterments made to the property.* No adjustment shall be made in respect of any item which, under any applicable provision of law or regulation, is treated as an item not properly chargeable to capital account but is allowable as a deduction in computing net or taxable income for the taxable year. For example, in the case of oil and gas wells no adjustment may be made in respect of any intangible drilling and development expense

[2] All references to "Treasury Regulations", "Treas. Regs.", or "Regulations", mean the Treasury Regulations in effect for the tax years at issue, 26 C.F.R.

allowable as a deduction in computing net or taxable income. *See* the regulations under section 263(c). (Emphasis added).

STATEMENT

1. During 1981 and 1982, Respondents (hereinafter referred to as "Taxpayers") were engaged in the business of oil and gas exploration, development and production. (Pet. App. 3a)[3] Taxpayers claimed depletion deductions of $439,884 for 1981, and $371,636 for 1982, on their federal income tax returns, with respect to their oil and gas properties. (Pet. App. 4a). Taxpayers paid a minimum tax of $29,812 for 1981 and $26,736 for 1982 with respect to the portion of their depletion deductions that constituted a tax preference item under Code section 57(a)(8). (A. 7)[4] Under Code section 57(a)(8), the amount of depletion that constitutes a tax preference item for the taxable year is the excess of the depletion deduction for that year over the adjusted basis of the property at the end of the year. Taxpayers determined the amount of their tax preference item by including the unrecovered cost of depreciable (tangible) improvements[5] to their oil and gas properties in the calculation of adjusted basis. (Pet. App. 6a) The Internal Revenue

[3] "Pet. App." refers to the Appendix to Petitioner's Petition for a Writ of Certiorari in this case.

[4] "A" refers to the Joint Appendix filed by Petitioner in accordance with Rules of the Supreme Court of the United States, Rule 26.

[5] "Depreciable improvements", "tangibles", or "tangible improvements" are the casing, pumps, pipes, well equipment and similar items connected to the mineral deposit for the purpose of developing and operating the property. *See* Treas. Reg. section 1.611-5(b)(4) and Treas. Reg. section 1.612-4(c)(1).

Service ("IRS") disputed Taxpayers' minimum tax calculation and asserted additional taxes owed. (A. 7) Taxpayers paid the resulting deficiencies under protest and filed a refund claim which the IRS denied. Thereafter, Taxpayers filed suit for refund in the Claims Court.

2. On Cross Motions for Summary Judgment, the Claims Court held that Taxpayers were entitled to include the unrecovered costs of the depreciable improvements to their oil and gas properties in the calculation of adjusted basis for purposes of Code section 57(a)(8). The Court of Appeals for the Federal Circuit affirmed, adopting the opinion of the Claims Court.

SUMMARY OF THE ARGUMENT

Ever since enacting the earliest income tax laws, Congress has maintained a policy of encouraging the development of our Nation's natural resources, through tax incentives, such as the percentage depletion deduction. *See Comm'r. v. Engle,* 464 U.S. 206, 208 (1984). In 1969, when Congress established the minimum tax, it intended to reduce the tax benefit derived from various deductions, such as the depletion deduction. However, in drafting Code section 57(a)(8), Congress had to determine how much of the depletion deduction could be subjected to the minimum tax without undermining the important tax incentive provided by the depletion deduction.[6] The critical focus, when analyzing how Congress resolved this policy dilemma, must be the words

[6] "A significant portion of the Nation's energy policy is located in the Internal Revenue Code, rather than in Federal outlay and regulatory programs." Joint Committee on Taxation, *Present Law and Proposals Relating to Increasing Domestic Energy Production and Reserves,* (JCS 23-90) July 26, 1990.

of the statute and the related regulations. *See Patterson v. Shumate,* 112 S.Ct. 2242, 2248 (1992); *United States v. Ron Pair Enterprises, Inc.,* 489 U.S. 235, 241 (1989).

1. Section 57(a)(8) requires taxpayers to pay a minimum tax for depletion only to the extent that the annual depletion deduction for each mineral property *exceeds the adjusted basis for that property.* Adjusted basis, for these purposes, is determined pursuant to section 1016 and the related regulations. *See* Treas. Reg. section 1.57-1(h)(3). Treas. Reg. section 1.1016-2(a), in turn, provides that the adjusted basis of property *includes the costs of improvements and betterments made to the property.* Petitioner has acknowledged that the tangible improvements at issue here are improvements to Taxpayers' mineral properties. Therefore, the Claims Court and the Court of Appeals correctly held that the unrecovered costs of these improvements should be included in the calculation of adjusted basis for purposes of Code section 57(a)(8).

2. Ignoring the unambiguous language of the Code and the Regulations, Petitioner argues that tangible improvements cannot be included in adjusted basis because of Code section 57(a)(8)'s reference to the definition of property in section 614. Section 614 defines the term "property" to mean each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land. Section 614 also provides extensive rules for determining when a taxpayer's separate interests can be combined into a single property. Section 614 does not, however, provide any rules for calculating the adjusted basis of the property. The definition of property under section 614 is only the starting point for calculating adjusted basis. Nothing in section 614, or the related regulations, directs taxpayers to ignore the

provisions of Treas. Reg. section 1.1016-2(a) when calculating adjusted basis under Code section 57(a)(8). Indeed, Treas. Reg. section 1.57-1(h)(3) directs that such rules be followed.

~~3.~~ Petitioner's argument mistakenly equates the calculation of adjusted basis under Treas. Reg. section 1.57-1(h)(3), with the calculation of depletable costs under Treas. Reg. sections 1.612-1(a) and (b)(1). Treas. Reg. section 1.57-1(h)(3) directs taxpayers to calculate adjusted basis, for purposes of Code section 57(a)(8), in accordance with the rules of Code section 1016 and the Regulations thereunder. These rules require that the cost of improvements be included in the adjusted basis of property without reference to the cost recovery method used for calculating the tax deductions associated with those improvements. Treas. Reg. sections 1.612-1(a) and (b)(1), on the other hand, direct taxpayers to calculate the depletable costs for a property pursuant to a *special rule* which specifically excludes tangibles from the calculation. The fact that Treas. Reg. sections 1.612-1(a) and (b)(1) prescribe a *special rule* that excludes tangibles from the calculation of adjusted basis, *for the limited purpose of calculating cost depletion,* confirms that for purposes of calculating adjusted basis under the *general rules* in Treas. Reg. section 1.1016-2(a), which apply for purposes of section 57(a)(8), the cost of tangibles is included in the computation.

4. Since the Petitioner cannot find support for its position in the Code and Regulations, it is urging this Court to ignore them and to focus instead on other factors, such as Petitioner's current view of the legislative intent. Petitioner's argument, however, begs the question of legislative intent by presuming a Congressional purpose consistent with its position. If Treasury had always interpreted legislative intent in a manner consistent with its litigating position in this case, it would have drafted Treas. Reg. section 1.57-1(h)(3) to include a special rule excluding tangibles from the calculation of adjusted basis. *See* Treas. Reg. sections 1.612-1(a) and (b)(1). As discussed in the preceding paragraph, however, no special rule was included in the section 57 Regulations. To the extent Congressional intent is relevant, Treasury's contemporaneous and long standing interpretation of the statute is a better guide than an interpretation advanced during this litigation.

ARGUMENT

I.

THE UNEQUIVOCAL LANGUAGE OF THE CODE AND REGULATIONS REQUIRES THAT TANGIBLE IMPROVEMENTS MUST BE INCLUDED IN ADJUSTED BASIS FOR PURPOSES OF CODE SECTION 57(a)(8).

A. The Code and Regulations Provide a Formula for Calculating Depletion as a Tax Preference Item Under Code Section 57(a)(8).

Code sections 56 and 57 establish a separate tax regime pursuant to which a minimum tax is imposed on a portion of certain tax deductions otherwise permitted under the Code.[7] The rules for determining what portion of those deductions constitute tax preference items and, hence, are subject to the minimum tax are set forth in Code section 57.

[7] During the years involved in this case, the minimum tax was 15% of the amount by which the sum of the taxpayer's "tax preference items", defined in section 57, exceeded certain deductions permitted under section 56.

Code section 57(a)(8) provides the formula for determining how much, if any, of a taxpayer's depletion deduction constitutes a tax preference item. This formula provides that the excess of the depletion claimed during the year with respect to each mineral property over the taxpayer's adjusted basis for that property, constitutes a tax preference item. Code section 57(a)(8) provides as follows:

> (a) *In General* – For purposes of this part, the items of tax preference are –
>
> (8) *Depletion* – With respect to each property (as defined in section 614), the excess of the deduction for depletion allowable under section 611 for the taxable year over the adjusted basis of the property at the end of the taxable year (determined without regard to the depletion deduction for the taxable year).

The property whose adjusted basis must be determined is defined by section 614 to mean each *separate interest* owned by the taxpayer in each mineral deposit. Code section 614(a) and Treas. Reg. section 1.614-1(a)(1). The regulations under Code section 57(a)(8) provide that the adjusted basis of the property is determined pursuant to Code section 1016 and the related regulations. *See* Treas. Reg. section 1.57-1(h)(3). Consequently, for minimum tax purposes, the adjusted basis of each property must be determined by taking into account all of the basis adjustments provided by Code section 1016 and the regulations thereunder.

B. Calculation of Adjusted Basis Under Section 1016.

The term "adjusted basis" is precisely defined in the Code and Regulations. (Pet. App. 11a). The adjusted basis of any property is its initial cost, adjusted as provided in Code section 1016. *See* Code sections 1011 and 1012, and Treas. Reg. section 1.1011-1. Pursuant to Treas. Reg. section 1.1016-2(a), the adjusted basis of any property includes "*the cost of improvements and betterments made to the property*." Treas. Reg. section 1.1016-2(a) provides, in pertinent part, as follows:

> The cost or other basis shall be properly adjusted for any expenditure. . . . or other item, properly chargeable to capital account, *including the cost of improvements and betterments made to the property*. (Emphasis added).

The Petitioner does not dispute that the tangibles at issue in this case are improvements and betterments to Taxpayers' mineral deposits. (Pet. App. 8a, A. 10, and Pet. Br. 11 and 23). Therefore, based on the clear and unambiguous language of Code section 57(a)(8), and the related regulations, the Claims Court and the Court of Appeals correctly held that, for purposes of computing depletion as a tax preference item, the adjusted basis of each of Taxpayers' oil and gas properties includes the costs of tangible improvements and betterments to those properties. (Pet. App. 11a). *See Patterson v. Shumate, supra*, at 2248; and *United States v. Ron Pair Enterprises, Inc., supra*, at 241.

C. The Plain Language of Treas. Reg. Section 1.1016-2(a) Requires That All Improvements Are Included In The Calculation of Adjusted Basis.

Although Petitioner admits that tangibles are improvements and betterments to the mineral deposit, it attempts to avoid the inevitable result of such admission by asserting that they are "separate properties" subject to different "cost recovery methods." (Pet. Br. 10-11, 23-24). Petitioner cites no authority for this proposition, except the statutory provisions and case law relating to the calculation of the tax deductions for depletion and depreciation. Clearly there are separate provisions in the Code for calculating depletion and depreciation.[8] However, the fallacy of Petitioner's analysis is that this case does not involve the calculation of the depletion deduction, *per se*. This case involves the determination of *how much* of the depletion deduction constitutes a tax preference item and is, therefore, subject to the minimum tax. (Pet. App. 9a).

The formula provided in Code section 57(a)(8) requires taxpayers to make this determination by reference to the adjusted basis of the property, computed in accordance with the rules of Code section 1016 and the related Regulations. Contrary to Petitioner's argument, nothing in the

[8]The depreciation deduction, however, is a factor in determining the allowable depletion deduction. Code section 613(a) limits the depletion deduction to 50% of the taxable income from the property. Taxable income is the gross income from the property, less all allowable deductions attributable to producing the mineral deposit. Depreciation of the improvements to the mineral deposit, is an allowable deduction in computing taxable income. Treas. Reg. section 1.613-5(a). *Thus, the depreciation deduction for tangibles reduces the taxable income from the property and thereby reduces the depletion allowance.*

language of either Code section 1016 or Treas. Reg. section 1.1016-2(a) limits the type of improvements which may be included in adjusted basis by reference to the cost recovery method used for calculating the tax deductions associated with those improvements.[9] Treas. Reg. section 1.1016-2(a) clearly contemplates a basis increase for the cost of *all* improvements or betterments to a mineral deposit, because it specifies that the adjusted basis *shall include* those costs. The use of the word "including" is a term of enlargement, not of limitation. *See Tele-Communications, Inc. v. Comm'r.*, 95 TC 495, 514 (1990), and *2A Sutherland's Statutory Construction*, §47.07, (5th Ed. 1992).

Code section 1016 does not predicate a basis adjustment on whether an expenditure is chargeable to a particular capital account. Rather, the phrase "properly chargeable to capital account" operates to distinguish capital expenditures made with respect to property, which increase adjusted basis, from currently deductible expenses which do not. An expenditure to repair property is normally deductible for tax purposes. Therefore, it is not properly chargeable to capital account and it cannot increase the property's basis under Code section 1016.[10]

[9]In Technical Advice Memorandum ("TAM") 8314011 (December 22, 1982), the IRS ruled that section 616 unamortized deferred mine development costs were includible in adjusted basis for minimum tax purposes, *even though they were not subject to depletion.* TAMs are cited herein as being representative of the IRS' administrative position. *See Rowan Companies, Inc. v. United States*, 452 U.S. 247, 261 (1981), n.17; *Hanover Bank v. Comm'r.*, 369 U.S. 672, 686-687 (1982).

[10]See the second sentence of Treas. Reg. section 1.1016-2(a), which provides that "No adjustment shall be made in respect of any item which, under any applicable provision of law or regulation, is treated as an item not properly chargeable to capital account but is allowable as a deduction in computing net or taxable income for the taxable year."

But, if the deduction is denied because the outlay adds to the value of the property or adapts it to a new purpose, the expenditure is properly chargeable to capital account and a basis increase is warranted.[11]

The tangible improvements at issue in this case are exactly the type of capital expenditures which section 1016 contemplates will be added to adjusted basis.[12] (Pet. App. 15a). They are expenditures made with respect to a mineral deposit which are not currently deductible for tax purposes.[13] They are not separate

[11] Treas. Reg. section 1.1016-2(a). The term "capital account" refers to fixed assets as a class. It is used in such expressions as "additions during the year to capital account." *See* Kohler, *A Dictionary for Accountants* (8th Ed. 1976, p. 80). *United States of America v. The Albertson Company*, 219 F.2d 920, 922 (1st Cir. 1955) ("certain expenditures are chargeable to capital account and, therefore, must be capitalized"); *Ralph E. Purvis*, 65 T.C. 1165, 1168 (1976) ("chargeable to capital account is used in the customary accounting sense of capitalization").

[12] *See* H.R. Rep. No. 179, 68th Cong., 1st Sess. (1924), *reprinted* in 1939-1 (Part 2) C.B. 241, 250: "Under this provision [the predecessor of section 1016] capital charges, such as improvements and betterments . . . are to be added to the cost of the property in determining gain or loss from its subsequent sale." Petitioner's example at Pet. Br. 24 at n.16 is misleading. It presumes that the parking garage is not an improvement to the shopping center, *i.e.*, not a capital addition, because it postulates that the garage is a separate property adjacent to the shopping center. If the parking garage were an addition to and built as part of the shopping center, it would be an improvement to that property and included in adjusted basis. *See* note 15, *infra*.

[13] The general rule under section 263 of the Code is that a taxpayer cannot deduct "any amounts paid for . . . permanent improvements or betterments made to increase the value of any property". Capital expenditures refer to amounts paid or incurred (1) to add to the value or substantially prolong the useful life of property owned by the taxpayer; or (2) to adapt property to a new or different use. Amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures. *See* Treas. Reg. sections 1.263(a)-1(a) and (b).

properties, as Petitioner maintains, because they are additions to and become part of the property improved. Tangibles are connected to the mineral deposit in order to enhance its value and its utility by developing and producing the mineral.[14]

The regulations do, as Petitioner points out, provide for the maintenance of a variety of accounts with respect to a mineral property (although these accounts are not referred to as capital accounts in the Regulations, as Petitioner maintains). *See* Treas. Reg. sections 1.611-2(b), 1.611-5(c); 1.167(a)-7. These accounts are used to keep track of and to calculate the tax deductions for the depletion and depreciation associated with a mineral property. They do not provide rules for calculating adjusted basis; nor do they provide a special rule which excludes certain kinds of improvements from the calculation.

Petitioner's reliance on the existence of these accounts is misconceived. The Code and the Regulations include improvements in adjusted basis because they are capital additions to the property improved; not because they are charged to any particular account or subject to any particular cost recovery method.[15]

[14] "Improvement": A valuable addition made to property or an amelioration in its condition, amounting to more than mere repairs . . . intended to enhance its value, utility or to adapt it for new or further purposes." *Black's Law Dictionary*, 5th Ed., p. 682. "Betterment": An improvement of an estate (as by the addition of new buildings) that makes it better and more valuable than mere repairing would; an expenditure that adds greater worth (as extended life or increased capacity) to a fixed asset. *Webster's Third New International Dictionary*, p. 209.

[15] If a taxpayer installs a new furnace in an old building he or she owns, the cost of the furnace would be kept in a separate account from the building because the cost recovery period and

[footnote continued]

D. Treas. Reg. Sections 1.612-1(a) and (b)(1) Confirm That Tangible Improvements Are Included in Adjusted Basis For Purposes of Code Section 57(a)(8).

The lower courts recognized that Petitioner's position, in this case is contrary to the Treasury Department's own Regulations. (Pet. App. 20 and 21a). Since January 20, 1960, Treas. Reg. sections 1.612-1(a) and (b)(1) have prescribed the method for determining cost depletion. Those Regulations provide that the adjusted basis for determining cost depletion is calculated under the general rules of Code section 1016 and the related Regulations, with only one exception. This exception creates a *special rule* which specifically excludes amounts recoverable through depreciation from adjusted basis, solely for purposes of calculating cost depletion. Treas. Reg. sections 1.612-1(a) and (b)(1) provide in pertinent part as follows:

> (a) *In general.* The basis upon which the deduction for cost depletion under section 611 is to be allowed in respect of any mineral or timber property is the adjusted basis provided in section 1011 for the purpose of determining gain upon the sale or other disposition of such property *except as provided in paragraph (b) of this section.* The adjusted basis of such property is the cost or other basis determined under section 1012, relating to the basis of property, *adjusted as provided in section 1016, relating to adjustments to basis, and the Regulations under such sections* . . . (Emphasis added).

depreciation method for the furnace would be different than for the building. The furnace could be removed from the building and, in that sense, could be considered a separate property. Nonetheless, the furnace is an improvement made to the building, and it is included in the adjusted basis of the building. Treas. Reg. section 1.1016-2(a).

> (b) *Special rules.* (1) The basis for cost depletion of mineral or timber property does not include:
>
> (i) *Amounts recoverable through depreciation deductions,* through deferred expenses, and through deductions other than depletion, and . . . (Emphasis added).

The plain language of these regulations illustrates that Petitioner's argument mistakenly equates the calculation of adjusted basis under Treas. Reg. section 1.57-1(h)(3) with the calculation of depletable costs under Treas. Reg. sections 1.612-1(a) and (b)(1). It is the calculation of adjusted basis under section 57(a)(8) which is at issue in this case. The "special rule" provided by Treas. Regs. section 1.612-1(a) and (b)(1) is not found in the section 57(a)(8) regulations. To the contrary, Treas. Reg. section 1.57-1(h)(3) mandates the ordinary section 1016 procedure by stating: "for the determination of the adjusted property at the end of the year, *see* Code section 1016 and the Regulations thereunder."

These Regulations negate all of Petitioner's attempts to create a theoretical justification for its deviation from the plain language and ordinary meaning of section 57(a)(8), and the related Regulations by reference to such concepts as the definition of property, a mineral deposit vs. mineral enterprise distinction, or a separate capital account rule. By specifying that for section 612 cost depletion purposes, a special rule applies which excludes tangibles from the calculation of adjusted basis, Treas. Reg. section 1.612-1 confirms that, absent a special rule, the adjusted basis of a mineral deposit would include depreciable improvements.[16] (Pet. App. 22a).

[16] The National Office of the IRS has also confirmed that a special rule must be specifically provided for before the general

[footnote continued]

E. The Definition Of "Property" Under Code Section 614 Does Not Exclude Depreciable Improvements From Adjusted Basis.

The property whose adjusted basis must be determined, for purposes of section 57(a)(8), is defined by section 614 as each *separate interest* owned by the taxpayer in each mineral deposit.[17] Section 614 also provides extensive rules for determining when a taxpayer's separate interests in a mineral deposit can be combined into a single property.[18] The determination of whether a taxpayer's separate interests are a single property or separate properties is important for a variety of purposes under the Code.[19]

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basis calculation rule in section 1016 will be ignored for minimum tax purposes: "the term 'adjusted basis' has the same meaning, whether used in section 57(a)(8), section 612, or elsewhere in the Code, except where the term is *specifically defined differently.*" (Emphasis added). TAM 8314011 (December 22, 1982).

[17] The term "interest" means an economic interest in a mineral deposit, and includes working or operating interests, royalties, overriding royalties, net profits interests and certain production payments. Treas. Reg. section 1.614-1(a)(2). There is no dispute that Taxpayers own an economic interest in their mineral deposits. *See* the Joint Appendix filed with the Court of Appeals for the Federal Circuit, p. 9. Each economic interest in a mineral deposit consists of different rights to the mineral production and different burdens with respect to the costs of the development and operation of the mineral deposit. For example, a royalty interest is not burdened with the cost of development, while a working interest must pay for the cost of the tangible improvements necessary for the development and operation of the property. *See* C.W. Russell, *Income Taxation of Natural Resources,* 202-206 (1991).

[18] Code sections 614(a), (b)(1), and (b)(2), 614(e) and Treas. Reg. section 1.614-8(a)(1). The single property resulting from a combination of separate interests or each separate property, if the interests are not combined, is treated as *the property* for all purposes under the income tax provisions of the Code.

[19] For example, depletion must be calculated separately for each section 614 property. *See* Code sections 612 and 613.

[footnote continued]

Code section 614 does not, however, contain any rules for determining what adjustments to the cost of that property are appropriate when calculating adjusted basis for purposes of Code section 57(a)(8). (Pet. App. 14a). Pursuant to Treas. Reg. section 1.57-1(h)(3), that subject is covered by section 1016 and, as described above, Treas. Reg. section 1.1016-2(a) directs taxpayers to increase the adjusted basis of property by the cost of improvements and betterments made to the property. The definition of property in section 614 is, therefore, only the starting point for the calculation of adjusted basis. Nothing in the language of Code section 614, or the related Regulations, directs taxpayers to exclude tangible improvements from the calculation of adjusted basis.[20]

The Petitioner's proposed interpretation of Code section 57(a)(8) "blurs the distinction between the property and the improvements to the property."[21] (Pet. App.

Gain or loss on sale is also computed separately for each property. *See* Code section 1011 and 1016. As indicated by Treas. Reg. section 1.57-1(h)(1), section 57(a)(8)'s reference to the section 614 property requires a separate calculation of depletion as a tax preference item for each separate property.

[20] Contrary to Petitioner's assertions, the section 614 Regulations illustrate that tangible improvements are part of the section 614 property. Treas. Reg. section 1.614-8(a)(1) states that the combination of separate interests does not preclude the use of more than one depreciation account for "improvements made with respect to the separate interests combined . . .". This Regulation illustrates that the accounts used for tax deduction purposes have nothing to do with whether an expenditure is an improvement to the section 614 property. *See,* also, Treas. Reg. sections 1.614-2(a)(2) and -3(a)(1) which contain similar language.

[21] Petitioner's reliance on the definition of a mineral enterprise at Treas. Reg. section 1.611-1(d)(3) is misconceived. This definition supports Taxpayers' position because it provides further evidence that Treasury has always treated tangibles as improve-

[footnote continued]

14a). There is no requirement in either section 614, section 57(a)(8), or section 1016, that an expenditure be a mineral deposit, *per se*, in order to be included in adjusted basis. All that is required, pursuant to Treas. Reg. section 1.1016-2(a), is that the expenditure constitutes an improvement to the property. Furthermore, Petitioner's argument is inconsistent with the undisputed way in which Petitioner treats intangible improvements.[22] Intangible improvements, such as road making, clearing ground,

ments to the mineral deposit. This definition is used to assist in identifying depletable and depreciable costs when an operating mineral property is acquired as a unit. *See* Treas. Reg. section 1.611-1(d)(4). Its use is for Part I - Deductions, Subchapter I (Natural Resources) of the Code and not for any other part of the Code. *See* Treas. Reg. section 1.611-1(d). The mineral enterprise definition does not address the computation of adjusted basis under section 1016; nor does it override the rule that that adjusted basis of property is its initial cost, plus the cost of improvements. Thus, the mineral enterprise concept is merely a red herring designed to distract this Court's attention from the plain language of Code section 1016 and the related Regulations.

[22] "Intangible improvements" or "intangibles" are expenditures for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas. Intangible improvements may, at the taxpayer's option, be chargeable to capital or to expense. Treas. Reg. section 1.612-4(a). If taxpayers elect to capitalize intangibles, their cost is recoverable either through depletion or depreciation. *See* Treas. Reg. sections 1.612-4(b)(1) and (2). Capitalized intangibles associated with physical property (*i.e.*, wages, fuel, repairs, hauling, supplies, etc. used in the installation of casing and equipment, and in the construction on the property of derricks and other physical structures) are returnable through depreciation. Treas. Reg. section 1.612-4(b)(2). Capitalized intangibles not represented by physical property (including expenditures for clearing ground, draining, road making, surveying, geological work, excavation, grading, and the drilling, shooting, and cleaning of wells) are returnable through depletion. Treas. Reg. section 1.612-4(b)(1).

excavating and grading, are no more mineral deposits than are tangible improvements, such as casing, pumps, pipes, and well equipment. Yet Petitioner argues that intangible improvements are included in adjusted basis, while tangible improvements are not included. The lower courts correctly found no basis for this distinction, for purposes of Code section 57(a)(8). (Pet. App. 14a and 15a). Both tangible and intangible improvements are included in adjusted basis, in accordance with Treas. Reg. section 1.1016-2(a), because they are both improvements to the property.

II.
THE LOWER COURTS' DECISIONS CORRECTLY INTERPRETED CODE SECTION 57(a)(8).

When Congress established the minimum tax, it clearly intended to reduce the tax benefit derived from the depletion deduction. But, in drafting section 57(a)(8), Congress had to balance its desire to reduce that tax benefit with its long-standing policy of encouraging the development of the Nation's natural resources.[23] A significant portion of this Nation's energy policy is found in the Internal Revenue Code.[24] Thus, it is probable or at least conceivable, as the lower courts recognized, that Congress sought to implement its plan to reduce the tax benefit provided by the depletion deduction, in a manner

[23] The percentage depletion deduction is a tax incentive, designed to subsidize the development of our Nation's natural resources and to encourage taxpayers to engage in that line of business. *See Comm'r. v. Engle*, 464 U.S. 206, 208 (1984), and *U.S. v. Swank*, 451 U.S. 571, 576 (1981).

[24] *Supra*, n.6.

that would not undermine its effectiveness as an incentive for the development of mineral deposits.[25]

Including tangibles in the formula for determining how much depletion is a tax preference item represents a reasonable compromise between these competing policy goals. It ameliorates the hardships created by Code sections 56 and 57, by applying the minimum tax, only after taxpayers have recovered their full investment in the property, including the cost of the tangible improvements which are necessary to develop and produce the mineral deposit.[26] Without the addition of tangible improvements to the property, there can be no production and, therefore, no depletion deduction to give rise to the minimum tax.[27] Affirming this decision does not allow

[25] The importance of percentage depletion as an incentive for the development of the domestic oil and gas industry is illustrated by the fact that one of the Administration's proposals to counteract our growing dependence on foreign oil, is to delete percentage depletion from the list of tax preference items in section 57. *See* Letter from President George Bush to Thomas S. Foley, Speaker of the House of Representatives, dated April 20, 1992, in support of H.R. 776. This revision would only affect small, independent oil and gas producers since large producers cannot claim percentage depletion. *See* Code Section 613A.

[26] If anything, the minimum tax has reduced the tax incentive provided by the depletion deduction too much for independent oil and gas producers. Congress is currently considering legislation which, for the time being, would delete percentage depletion from the list of tax preference items. The Committee Reports to this legislation indicate Congress' belief that the effectiveness of the oil and gas incentives for domestic drilling and production have been reduced too much. *See Comprehensive National Energy Act* (H.R. 776), H.R. Rept. 102-474, 102nd Cong. 2d Session 43-44, and S.R. Rept. 102-95, 19-21. If this legislation becomes law, the issue raised by this case will become moot for independent oil and gas producers, such as Taxpayers, through 1997.

[27] Code section 613(a) only permits a deduction for depletion if there is gross income from the property.

taxpayers to escape the impact of the minimum tax, as Petitioner's hyperbole suggests. Taxpayers did, in fact, report and pay a minimum tax for percentage depletion of $29,812 for 1981 and $26,736 for 1982, using the method approved by the lower courts. (*See* A.7).

Nothing in the legislative history to section 57(a)(8) indicates that Congress intended to deviate from the general basis rules under Treas. Reg. section 1.1016-2(a), or that it desired to follow the long standing special basis rule of Treas. Reg. sections 1.612-1(a) and (b)(1).[28] When the Treasury Department drafted the proposed regulations under Code section 57(a)(8), shortly after that section's enactment, it apparently did not perceive the legislative intent to be that tangibles should be excluded from the calculation of adjusted basis.[29] Otherwise,

[28] As the Claims Court found, "there are brief statements that arguably benefit each side, but nothing definitive." Pet. App. 15a, n.10. Moreover, Petitioner has previously admitted that the legislative history was "not all that helpful." Pet. App. 15a, n.10. The 1986 Committee Report, cited by Petitioner, actually supports Taxpayers because the reference to the adjusted basis of the depletable property confirms that the Code section 1016 meaning of that term should apply. The 1969 Committee Report uses the term "property", as defined in section 614, not the term depletable property. Furthermore, the term depletable property no more defines what basis adjustments are appropriate under section 1016 than does the term section 614 property. It is the Treasury Regulations under Code section 1016 which describe the proper calculation for adjusted basis. Moreover, although this history supports Taxpayers, they acknowledge that the views of a 1986 Congress, as to the construction of a statute adopted many years before by a 1969 Congress, have very little, if any, relevance and, this Court has determined, are not part of the legislative history. *Weinberger v. Rossi*, 456 U.S. 25, 35 (1982); *Andrus v. Shell Oil Co.*, 446 U.S. 657, 666, n.8 (1980); *Oscar Mayer & Co. v. Evans*, 441 U.S. 750, 758 (1979).

[29] *See* Prop. Reg. section 1.57-1(h)(3), originally proposed on December 30, 1970, 35 Fed. Reg. 19, 768 (Dec. 30, 1970).

[footnote continued]

Treasury would have drafted Treas. Reg. section 1.57-1(h)(3) to incorporate the special rule of Treas. Reg. sections 1.612-1(a) and (b)(1), excluding tangibles from adjusted basis.[30] The clarity of Treas. Reg. section 1.57-1(h)(3) makes it obvious as to what the drafters of those regulations understood to be the Congressional intent.[31] *See Patterson v. Shumate, supra, Toibb v. Radloff*, 111 S.Ct. 2197 (1992), *United States v. Ron Pair Enterprises, supra*, 241, *Consumer Product Safety Comm'n. v. GTE Sylvania, Inc.*, 447 U.S. 102, 108 (1990).

III.
THE TREASURY DEPARTMENT IS BOUND TO FOLLOW ITS OWN REGULATIONS.

Taxpayers navigated the maze of Regulations under Code sections 57, 614 and 1016 when they prepared their federal income tax returns and they calculated their minimum tax in accordance with the plain meaning of those rules. They followed the clear language of Treas. Reg. section 1.1016-2(a), which directs that the cost of improvements and betterments made to the property be included in the calculation of adjusted basis. Petitioner

The final regulations were issued without any change in this language.

[30]Treas. Reg. sections 1.612-1(a) and (b) had been outstanding for approximately ten years at the time Treas. Reg. section 1.57-1(h)(3) was originally proposed. *See* T.D. 6446, 1960-1 CB 208.

[31]A substantially contemporaneous and long standing construction by the Treasury Regulations is presumed to reflect Congressional intent. *National Muffler Dealers Association, Inc. v. United States*, 440 U.S. 472, 477, 489 (1979); *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844 (1984).

is now telling Taxpayers that what the Treasury Department really intended to do was to draft Treas. Reg. section 1.57-1(h)(3) so that it contained the *special rule* found in Treas. Reg. sections 1.612-1(a) and (b)(1).[32] The Claims Court and the Court of Appeals properly rejected the Petitioner's argument, stating:

> "A taxpayer is entitled to . . . consistency in definition. Where Congress and the Department of Treasury choose to employ a technical term such as 'adjusted basis,' a taxpayer must be given reasonable notice when the term is intended to have other than its ordinary meaning in the Code. Herein, no such notice was supplied, and plaintiffs [Taxpayers] calculated their taxes according to the ordinary meaning of the terms in the controlling statutes and regulations. Taxpayers can be expected to do no more. Taxpayers are obliged to do no more." (Pet. App. 22a).

This is not the first case where the Treasury Department has attempted to ignore the plain meaning of its own regulations, and it may not be the last. But the courts have consistently rejected those attempts, because Treasury Regulations are as binding on the Treasury Department as they are on taxpayers.[33] The complexity

[32]"This phenomenon calls into question whether our legal culture has so far departed from attention to text or is so lacking in agreed-upon methodology for creating and interpreting text, that it no longer makes sense to talk of 'a government of laws, not of men'." Justice Scalia's concurring opinion in *Patterson v. Shumate*, 112 S.Ct. at 2250-51.

[33]*Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939); *McCord v. Granger*, 201 F.2d 103 (3d Cir. 1952); *Mutual Savings Life Insurance Co. v. United States*, 488 F.2d 1142, 1145 (5th Cir. 1974); *Pacific National Bank of Seattle v. Comm'r.*, 91 F.2d 103, 105 (9th Cir. 1937); *Lansons, Inc. v. Comm'r.*, 622

[footnote continued]

of our self-assessment tax law requires that taxpayers be entitled to rely on the plain meaning of the Treasury Department's Regulations. Fairness requires that Treasury Regulations not be subject to different interpretations in accordance with Treasury's varying budgetary needs.[34] The tax law should be fairly applied, based on the plain meaning of the Code and the Regulations, not the revenue impact.

If the Treasury Department is now dissatisfied with its clear and unambiguous Regulations, or believes that they provide taxpayers with an unintended benefit, it should seek revisions by Congress, or should attempt to revise its regulations. However, when the Treasury Department has not taken steps to amend the regulations, its failure to use its broad power in this area does not justify judicial interference in what is essentially a legislative and administrative matter.[35]

F.2d 774, 776 (5th Cir. 1980); *Brafman v. United States*, 384 F.2d 863, 866 (5th Cir. 1967); *Tipton and Kalmback, Inc. v. United States*, 480 F.2d 1118, 1121 (10th Cir. 1973).

[34] No foundation for Petitioner's revenue estimates is found in the record.

[35] *Woods Investment Co. v. Comm'r.*, 85 T.C. 274, 282 (1985); *Henry C. Beck Builders, Inc. v. Comm'r.*, 41 T.C. 616, 628 (1964); *Transco Exploration Co. v. Comm'r.*, 95 T.C. 373, 384 (1990), *aff'd*, 949 F.2d 837 (5th Cir. 1992); *T. Jack Foster v. Comm'r.*, 25 T.C.M. (CCH) 1390, 1417 (1966); *Idaho First National Bank v. Comm'r.*, 95 T.C. 185, 193 (1990); *Honeywell, Inc. v. Comm'r.*, 87 T.C. 624, 635 (1986).

CONCLUSION

The Court of Appeals' decision should be affirmed.

Respectfully submitted,

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(8)

No. 91-1421

In the Supreme Court of the United States

OCTOBER TERM, 1992

UNITED STATES OF AMERICA, PETITIONER

v.

WILLIAM F. HILL AND LOLA E. HILL

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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1. a. Respondents (Br. 9, 17-18) and *amici* (Br. 7-10) assert that, under Section 1016 of the Code, all capital improvements to an asset are "properly chargeable" to the capital account of that asset. They therefore contend that, both under Section 1016 and for purposes of calculating the depletion tax preference under Section 57(a)(8), the cost of "improvements" associated with a "mineral enterprise" are to be added to the basis of the "mineral deposit." These assertions, which also form the basis of the decision in the courts below (Pet. App. 7a-9a), are fundamentally flawed.

Some types of "improvements" to an asset are so completely merged into that asset that the cost of the "improvements" are commingled with the costs of the

asset into a single basis for tax accounting purposes. A simple example is a "new and improved" component placed in manufacturing machinery; the component represents an "improvement" to the machinery, and its costs are added to the adjusted basis of the machinery. The costs of such an "improvement" are to be recovered through the depreciation (or disposition) of the resulting, combined asset. See, *e.g.*, 26 C.F.R. 1.1016-2(b); *Jefferson Memorial Gardens, Inc.* v. *Commissioner*, 390 F.2d 161 (5th Cir. 1968) (cost of streets and similar improvements to a subdivision are allocated among the bases of the subdivision lots).

Other types of "improvements" *themselves* represent separate assets and their costs are maintained, and recovered, in separate accounts for tax purposes. For example, a new machine added to a factory may be said to represent an "improvement" to the manufacturing enterprise, but the costs of the machine and the factory are *not* commingled into a single basis. Instead, separate capital accounts are maintained for the factory and the "improvement" and the costs of the two assets are recovered independently. See, *e.g.*, *Noell* v. *Commissioner*, 66 T.C. 718, 723-724 (1976) (air strip built on land within subdivision is a separate asset and its costs are not allocated to the bases of the subdivision lots).

The tax accounting applicable to a "mineral enterprise"—which, by definition, consists of a "mineral deposit * * * and improvements" (26 C.F.R. 1.611-1(d)(3))—is of the latter type, for the costs of tangible "improvements" to the mineral enterprise are separately accounted for and separately recovered. The costs of the "mineral deposit"—which represents the "minerals in place"—are maintained in a

capital account for that deposit and are recovered by the allowance for depletion. 26 U.S.C. 611(a). The costs of associated tangible improvements—such as wellhead equipment and piping—are maintained in an "improvements account" (26 C.F.R. 1.611-2(b)(2)) and are recovered upon their sale or by an allowance "for depreciation of improvements" (26 U.S.C. 611(a)).[1] To emphasize that a separate accounting is required for the depletable costs of the "mineral deposit" and the depreciable costs of "improvements" to the mineral enterprise, the regulations specify that "[i]n no event shall percentage depletion in excess of cost or other basis of the [mineral deposit] be credited to the improvements account" (26 C.F.R. 1.611-2(b)(2)).[2] See also 26 C.F.R. 1.612-1(b)(1) (the basis of a depletable mineral deposit "*does not include* * * * [a]mounts recoverable through depreciation deductions") (emphasis added).[3]

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[1] The tangible "improvements" to an oil well, such as pipes and wellhead equipment, are removable, separately valuable, and have useful lives of varying lengths reflected in applicable depreciation schedules. The costs of such improvements are recoverable by depreciation. By contrast, the term "mineral deposit" refers "to minerals in place" (26 C.F.R. 1.611-1(d)(4)), and the costs of a mineral deposit are recoverable through depletion.

[2] The regulation uses the word "property" instead of "mineral deposit," as reflected in the brackets in this quotation. See 26 C.F.R. 1.611-2(b)(2). The regulation defines the word "property," however, as the "mineral deposit" in which the taxpayer owns an interest. 26 C.F.R. 1.611-1(d)(1)(i).

[3] Respondents and *amici* implicitly acknowledge that this regulation, if applicable, disposes of their claim. But they contend (Resp. Br. 14-15; Amicus Br. 10, 17-18) that the

These long-standing statutory and regulatory provisions thus expressly provide that the cost of a depreciable "improvement" to a mineral enterprise is *not* "properly chargeable" (26 U.S.C. 1016(a)) to the capital account of a "mineral deposit."[4] See also

regulation is of limited significance because it describes the calculation of the basis of the mineral deposit only for *cost* depletion purposes. That contention is in error. The same calculation applies in determining the basis of the mineral deposit whether *cost* or *percentage* depletion is employed. The percentage depletion regulations emphasize this point, for they specify that a percentage depletion deduction in excess of the basis of the mineral deposit may *not* be credited to the separate "improvements account" that is to be maintained for depreciable improvements. 26 C.F.R. 1.611-2(b)(2). Since the percentage depletion allowance may not be credited to the "improvements account," and is therefore not to be employed to recover the basis of depreciable improvements, the cost of such improvements obviously is not to be included in the basis of the depletable mineral deposit. Both for cost depletion and percentage depletion purposes, the basis of the depletable mineral deposit thus "does not include * * * amounts recoverable through depreciation deductions" (26 C.F.R. 1.612-1(b)(1)).

[4] Respondents contend (Br. 11-12) that the provisions of Section 1016 that allow additions to basis only of costs "properly chargeable" to the capital account of an asset (26 U.S.C. 1016(a)) serve only to distinguish between currently deductible and capital expenses associated with "improvements." Certainly, only capital expenses are "properly chargeable" to basis; currently deducted expenses, by definition, have been recovered and should not be included in basis. As we have explained in the text, however, the costs of *separate* assets, to be recovered under *separate* methodologies, are also *not* to be commingled into a single basis and are thus not "properly chargeable" to the same capital account. See *Tolwinsky* v. *Commissioner*, 86 T.C. 1009, 1054 (1986) (the expenses " 'must be made *with respect to such property*' in order to be

Holbrook v. *Commissioner*, 65 T.C. 415, 420 (1975) (improvements consisting of depreciable equipment do not constitute capital investments in the minerals in place). The cost of depreciable improvements therefore may *not* be added to the basis of the depletable mineral deposit in determining the amount of percentage depletion that constitutes a tax preference under Section 57(a)(8) of the Code.[5] See Pet. Br. 15-28.

The legislative history of Section 57 reflects this very conclusion, for, in amending and reenacting Section 57(a)(8) in 1986, Congress expressly stated that only the unrecovered basis of the "depletable" mineral deposit may be considered in calculating the tax preference resulting from the percentage depletion allowance. See H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. Pt. 2, at 254 (1986); Pet Br. 26. The many commentators who have addressed this issue have uniformly reached that same conclusion. See

included in the depreciable basis of such property") (quoting 3A J. Mertens, *Law of Federal Income Taxation* § 21.22 (1977)); *Purvis* v. *Commissioner*, 65 T.C. 1165, 1168 (1976) (the expense must represent "an addition" to the asset). The separate bases maintained for *depletable* mineral deposits and for *depreciable* improvements (see 26 C.F.R. 1.611-2(b)(2)) are a classic illustration of this principle.

[5] Examples of improvements whose costs *may* be added to the basis of the mineral deposit, and which are recoverable through depletion, are intangible drilling costs that are not currently deducted. See 26 C.F.F. 1.612-4(a), (b)(1) and (b)(2). As we explain in our opening brief (at 26-27), these capitalized intangible costs have long been recognized as a part of the cost, or an addition to the value, of the oil in the ground. See *United States* v. *Dakota-Montana Oil Co.*, 288 U.S. 459, 466 (1933).

Pet. Br. 26, 30 n.20. See also Lawson, *Alternative Minimum Tax: The Percentage Depletion Tax Preference for Investments in Natural Resources After* Hill *v.* United States, 7 J. Min. L. & Pol. 211, 217 (1992) (the court of appeals "reached the wrong conclusion in *Hill*").[6]

b. All of respondents' contentions miss, or evade, the basic fact that the mineral deposit and the associated "improvements" to the mineral enterprise represent separate properties, each with its own capital account and basis. They are treated separately precisely because they are subject to different methods of cost recovery. See *Commissioner* v. *Ferrer*, 304 F.2d 125, 135 (2d Cir. 1962) (separate bases must be maintained for two closely related assets when "part of a transaction calls for one tax treatment and another for a different kind"). If, as respondents assert (Br. 12-13), depreciable tangible improvements "are not separate properties * * * because they are additions to and become part of the property improved," then the costs of depreciable improvements necessarily would be recovered by depletion, rather than by depreciation. Both the statute (26 U.S.C. 611(a)) and the regulations (26 C.F.R. 1.611-2(b)(2)) make clear, however, that the costs of tangible improvements are separately maintained in an "improvements account" (*ibid.*) and are to be recovered by the allowance for "depreciation of improvements" (26 U.S.C. 611(a)), not by depletion.

c. *Amici* fundamentally misstate our position by asserting (Br. 10) that the government "agree[s] that when the *mineral property* is sold, the adjusted basis for computing gain or loss must include these tangible improvements" (emphasis added). The portion of our brief that they cite (Pet. Br. 24) does not support this statement. Instead our brief states that, while tangible "improvements" (*ibid.*)

> may be properly includable in the basis of the "mineral enterprise" for the purpose of determining gain on sale of the mineral enterprise as a unit * * * , those depreciable "improvements" have their own capital accounts, separate and distinct from the capital account of each depletable mineral deposit that is a component part of the mineral enterprise.

The term "mineral property," used by *amici* (Br. 10), is a defined regulatory term that refers specifically and exclusively to the "mineral deposit" (26 C.F.R. 1.611-1(d)(1)). The term "mineral enterprise," used in the cited quotation from our opening

[6] "Although the difference between depletion and depreciation was not recognized by the *Hill* court, many other authorities have understood the distinction. For example, the Tax Court held in *Clemente, Inc.* v. *Commissioner* [50 T.C.M. (CCH) 497 (1985)] that a proper computation of the depletion allowance for a property should be determined only after removing the nondepletable assets from the basis. The Internal Revenue Service (IRS) held in a revenue ruling that the cost of acquiring a mineral enterprise should properly be allocated between the property's depletable and depreciable bases. [Rev. Rul 69-539, 1969-2 C.B. 141.] Also, tax commentators on natural resources have agreed that 'the [property's] depletable basis does not include * * * wasting assets such as equipment and improvements that are subject to * * * depreciation.' These authorities uniformly agree that depreciation and depletion are entirely separate concepts for purposes of regular and minimum tax; therefore, the *Hill* court contradicted logic and reason by allowing unrecovered tangible costs to be included in the property's depletable basis." Lawson, *supra*, 7 J. Min. L. & Pol. at 220 (footnotes omitted).

brief (Pet. Br. 24), is also a defined regulatory term that refers *not* to the mineral "property," as *amici* erroneously suggest, but to the "mineral deposit * * * and improvements" (26 C.F.R. 1.611-1(d)(3)). By blurring the distinction between the term "property" ("mineral deposit") and the term "mineral enterprise," *amici* seek to blur the very issue presented in this case. For, in calculating tax preference income in Section 57(a)(8), Congress has allowed the taxpayer to set off only the adjusted basis of the "property" (defined as the "mineral deposit") and *not* the adjusted basis of the entire "mineral enterprise." See 26 U.S.C. 57(a)(8) (1976), incorporating 26 U.S.C. 614. The courts below erred precisely by allowing a deduction of the basis of the entire "mineral enterprise" in this calculation, for they allow the taxpayer to set off the basis of the "mineral deposit * * * and improvements."

In enacting Section 57(a)(8), Congress legislated against the background of these clear statutory and regulatory distinctions. If Congress had intended the result adopted by the courts below, Section 57(a)(8) would have referred not to the adjusted basis of the "mineral deposit" but to the unrecovered costs of the "mineral enterprise." By adhering to the longstanding distinction between the separate capital accounts maintained for the depletable mineral deposit and for depreciable tangible "improvements," Congress properly focused the tax preference calculation on the area of its concern. For, as we have explained (Pet. Br. 16-21), it is excess depletion of mineral deposits, not the ordinary "depreciation of improvements" (26 U.S.C. 611), that makes the depletion allowance potentially unfair and subject to economic abuse.

d. Respondents (Br. 11 n.9, 15-16 n.16) and *amici* (Br. 19-20) erroneously assert that the position of the United States in this case is inconsistent with Tech. Adv. Mem. 83-14-011, issued by the Internal Revenue Service on December 22, 1982.

By statute, this memorandum (and other similar informal advice from the Service) "may not be used or cited as precedent." 26 U.S.C. 6110(j)(3). The memorandum, in any event, concerns the special treatment afforded to a category of mining costs described as "deferred" "development expenditures" (26 U.S.C. 616(a), (b)), a category of costs that does not exist for any "oil or gas well" (26 U.S.C. 616(a)). The memorandum concludes that such deferred development expenses—which may *not* include the costs of assets that are "subject to * * * depreciation" (*ibid.*)—may be included in the adjusted basis of the "property" in calculating the depletion tax preference under Section 57(a)(8). This conclusion simply implements the plain language of Section 616(c), which specifies that the deferred development expenses described in the statute "shall be taken into account in computing the adjusted basis of the mine or deposit" (26 U.S.C. 616(c)).[7]

The Service stated in that memorandum that the "adjusted basis' of the property is a term that has the same meaning in Section 57(a)(8) as it has "elsewhere in the Code." The Service's position in this case is consistent with that statement. It is, after

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[7] The deferred development expenses described in Section 616 are analogous to the intangible drilling costs that are included in the basis of a mineral deposit when the taxpayer elects to capitalize, rather than deduct currently, those costs. See Pet. Br. 17-18 n.12; note 5, *supra*.

all, the Service's view that the adjusted basis of the depletable "mineral deposit" is the same for purposes of the tax preference calculation under Section 57(a)(8) as it is under Section 611 and "elsewhere in the Code." It is *respondents* who claim that the cost of depreciable tangible improvements should be added to the basis of the mineral deposit under Section 57 even though, under Section 611, those improvements are separately accounted for in an "improvements account" (26 C.F.R. 1.611-2(b)(2)), with the associated costs recovered by "depreciation of improvements" (26 U.S.C. 611), rather than by depletion (26 C.F.R. 1.611-2(b)(2)). See pages 1-7, *supra*.

For more than fifty years, the statute and regulations have consistently required that depletable mineral deposits and depreciable tangible improvements be treated as separate items of property. During that same period, the Service has consistently expressed that same requirement (G.C.M. 17,760, 1937-1 C.B. 102, 104-105):

> The Bureau has consistently required the owners of improved mineral property to keep separate accounts for depletable and depreciable property * * *.
>
> * * * [This] requirement renders it necessary that the basis of depletable property be set up as an item separate from the basis of depreciable property.

See also *Holbrook* v. *Commissioner*, 65 T.C. at 420; Russell & Henderson, *Purchase of a Producing Oil and Gas Well: Is Cost of the Cased Shaft Recoverable Through Depreciation?*, 35 Oil & Gas Tax Q. 177, 179 (Dec. 1986) ("'Improvements' and 'oil and gas in place' are mutually exclusive. Improvements are depreciated; oil and gas in place is depleted.").

2. In enacting the minimum tax, Congress sought to capture and tax the special benefit that excess percentage depletion deductions provide for mineral producers because that benefit creates "an unfair distribution of the tax burden" (S. Rep. No. 552, 91st Cong., 1st Sess. 112 (1969)) and "impair[s] the equity of the tax system" (S. Rep. No. 938, 94th Cong., 2d Sess. 109 (1976)). As explained in our opening brief (at 28-31), this clear, expressed intent of Congress is frustrated and impeded by the decision in this case, which (i) illogically combines the unrecovered costs of depreciable tangible assets with the basis of the depletable mineral deposit in determining the tax preference resulting from *excess depletion* and (ii) allows the taxpayer to set off the unrecovered balance of depreciable costs *each year*, even when the depletion allowance in the prior years far exceeds the taxpayers' basis both in its depletable *and* depreciable property (see Pet. Br. 6 n.6). For these reasons, as commentators have uniformly concluded, the result reached by the court of appeals is "completely inconsistent with the purpose of the minimum tax" (Lawson, *supra*, J. Min. L. & Pol. at 221).

Respondents do not attempt to justify these obvious logical flaws in the decision below. Instead, respondents suggest that it is "conceivable" (Br. 19) that Congress silently intended to adopt such an illogical scheme in order substantially to mitigate the effect of the minimum tax on the incentive that percentage depletion provides to mineral development. But the "incentive" that respondents claim Congress silently sought to protect is simply the financial flipside of the "inequity" that Congress expressly sought

to curtail in the minimum tax. Boiled down to its essence, respondents' suggestion appears to be that the clear language of Section 57(a)(8)—which invokes the established and logical distinction between depletable mineral deposits and depreciable tangible improvements and implements the express congressional policy to employ the minimum tax to enhance the equity of the tax system—should be ignored because Congress "conceivabl[y]" might have intended some other, contrary result. That contention, of course, lacks any support. By entrenching the same "unfair distribution of the tax burden" that the statute is designed to correct (S. Rep. No. 552, *supra*, at 112), the courts below erred in their reading of the language, the history and the purpose of the statute.

The judgment of the court of appeals should be reversed.

Respectfully submitted.

KENNETH W. STARR
Solicitor General

SEPTEMBER 1992

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No. 91-1421

In the Supreme Court of the United States

OCTOBER TERM, 1992

UNITED STATES OF AMERICA, PETITIONER

v.

WILLIAM F. HILL AND LOLA E. HILL

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

SUPPLEMENTAL BRIEF FOR THE UNITED STATES

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On October 24, 1992, the President signed into law the Energy Policy Act of 1992, H.R. 776, 102d Cong., 2d Sess. Section 1915(a) of the Act amends Section 57(a)(1) of the Internal Revenue Code and provides that, for years after December 31, 1992, the depletion allowance for oil and gas production that is permitted for independent oil and gas producers and royalty owners under Section 613A(c) of the Internal Revenue Code will *not* be treated as an item of tax preference subject to the minimum tax.

Since respondents' percentage depletion allowance for oil and gas production is taken pursuant to Section 613A(c) of the Code, their allowance for years *after* 1992 will not be subject to the minimum tax, as

the statute has now been amended. The amendments adopted in Section 1915 of the Energy Policy Act of 1992, however, do not alter or affect respondents' minimum tax liability for the years *before* 1992 that this case involves. The amendments also do not alter or affect the minimum tax liability of producers of *other* types of minerals—such as coal and hard mineral producers like *amici* The National Coal Corporation, *et al.*—for percentage depletion allowances authorized under Section 613 of the Internal Revenue Code for years before or after 1992.

Respectfully submitted.

KENNETH W. STARR
Solicitor General

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BRIEF OF AMICI CURIAE THE NATIONAL COAL ASSOCIATION, CYPRUS MINERALS COMPANY, INDEPENDENCE MINING COMPANY INC., THE NORTH AMERICAN COAL CORPORATION, REDLAND INC., AND THE UNITED COMPANY IN SUPPORT OF RESPONDENTS

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STATEMENT OF INTEREST *

The National Coal Association is a non-profit trade association, with over 140 members, representing coal mining companies that own or operate more than 70 percent of the Nation's coal producing capacity. NCA producer

* Counsel for all parties have consented to the filing of this amicus brief. *Amici* have filed those consents with the Clerk of this Court.

members range from companies mining several thousand tons of coal yearly to large corporations producing millions of tons annually. NCA's members also include other key segments of the industry—coal sellers, equipment suppliers, resource developers, transporters electric utilities, consultants and 32 state and regional associations. NCA is the principal spokesman for the United States coal industry.

The individual amici are engaged in the mineral extraction industry, and their tax liabilities are governed by the same minimum tax provision as the respondents in this case.

The result in this case, which involves oil and gas, will govern the hard minerals industry as well. Therefore, these amici or their members would suffer direct injury should petitioner succeed in establishing a new meaning of "adjusted basis of the property" for purposes of 26 U.S.C. § 57(a).

SUMMARY OF ARGUMENT

I.

This case involves the interpretation of a statute, 26 U.S.C. § 57(a)(8), which is part of the "minimum tax" provisions of the Internal Revenue Code. The minimum tax imposes a special levy on certain amounts that are excluded from the base of the income tax, as a result of various deductions or other benefits. Section 57(a)(8) subjects to the minimum tax a portion of a taxpayer's "percentage depletion" deductions, which the tax law provides in order to encourage mineral exploration and development.

Section 57(a)(8) provides that, for any taxable year, a taxpayer's percentage depletion deductions with respect to a mineral property shall be subject to the minimum tax *only* to the extent the deductions exceed the "adjusted basis of the property" at the end of the year. This case

involves the specific question whether the cost of depreciable tangible improvements to a mineral property, such as the pipes, pumps and other equipment necessary to operate respondents' property, shall be included in that property's "adjusted basis" for purposes of section 57(a)(8).

Congress enacted section 57(a)(8) against the background of a long history of interpretation under which the adjusted basis of a property, as defined under 26 U.S.C. § 1016, includes the cost of improvements to that property. Petitioner does not challenge this established understanding of "adjusted basis." Instead, petitioner urges that Congress should be assumed to have adopted a special definition appearing in a regulation under a provision of the Code not at issue here—a provision governing "cost," not "percentage," depletion. The special definition cited by petitioner by its terms applies *only* to cost depletion; moreover, the very need for that regulation, which provides a special meaning of "adjusted basis" for the limited purpose of the cost depletion rules, supports the view that the regular meaning of "adjusted basis" should apply in other areas. Against this background there is no ground for suggesting that Congress departed from the general definition of "adjusted basis."

II.

Even if 26 U.S.C. § 57(a)(8) were ambiguous, petitioner's own administrative interpretations make clear that the regular definition of "adjusted basis" is to apply.

This Court has "long recognized that considerable weight should be accorded to an executive department's construction of a statutory scheme that it is entrusted to administer . . . ." *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844 (1984). Inherent in this rule is the principle that a government agency should not be permitted to disavow its own interpretations.

Petitioner's regulation, 26 C.F.R. § 1.57-1(h)(3)—the *only* regulation that directly addresses the meaning of "adjusted basis" for purposes of section 57(a)(8)—makes plain that the ordinary meaning of that term, as established at 26 U.S.C. § 1016 and in the regulations thereunder, should be applied. The regulations under section 1016, moreover, provide flatly that a property's basis is to be adjusted for the cost of improvements to the property. A 1982 technical advice memorandum issued by petitioner confirms this interpretation in the context of section 57(a)(8) itself.

Petitioner should not now be permitted, in the course of its appellate briefs, to substitute a new interpretation of the statute for the interpretation set forth in its own regulations. *Bowen v. Georgetown University Hospital*, 488 U.S. 204, 212 (1988).

ARGUMENT

I. THE PLAIN MEANING OF THE STATUTE CONTRADICTS THE GOVERNMENT'S INTERPRETATION.

This case involves two provisions of the Internal Revenue Code, 26 U.S.C. § 57(a)(8) and 26 U.S.C. § 1016(a), which are designed to operate in tandem.[1]

Section 57(a)(8) is part of the "minimum tax" provisions of the Code, which have existed in various forms since 1969.[2] The minimum tax is a superstructure placed

[1] Unless otherwise specified, all citations will be to the Internal Revenue Code and the Treasury Regulations in effect in the tax years 1981 and 1982, the years at issue in this case.

[2] Pub. L. No. 91-172, § 301, 83 Stat. 581 (1969). Although the provisions of the minimum tax have been amended many times, the language of 26 U.S.C. § 57(a)(8) has remained unchanged since its original enactment. *See* Pub. L. No. 91-172, § 301, 83 Stat. at 582.

As a result of a restructuring of the minimum tax provisions in 1986, the language of section 57(a)(8), as it stood in the tax years at issue in this case, is now found at section 57(a)(1). Pub. L. No.

on the general provisions of the Code. It was motivated by a congressional perception that various deductions and other tax benefits of the regular tax rules resulted, in some circumstances, in excessively low overall tax burdens for particular taxpayers. *See* H.R. No. 413, 91st Cong., 1st Sess. at 77-80 (1969). Thus, the minimum tax imposes a special levy on certain items that are excluded from the base of the regular income tax, as a result of various favorable deductions or other benefits that Congress has allowed in order to encourage particular kinds of economic activities. The regular tax benefits that the minimum tax to some extent "takes back" are commonly known as "preference items."[3]

Among the preference items that the minimum tax addresses is the "percentage depletion" allowance of 26 U.S.C. § 613 and related provisions of the Code. The Code provides two methods of calculating depletion. One method, "cost depletion," is in essence quite simple. If, for example, a taxpayer paid \$1 million for an interest in a mineral property, and the mineral removed from the property in a particular year represents 10 percent of the estimated total mineral recoverable from the property, the taxpayer's annual deduction would be \$100,000. Under cost depletion, once the cost of the deposit (\$1 million in the example above) is fully recovered, no further depletion deductions are allowed.

99-514, § 701, 100 Stat. 2330, 2333 (1986). This brief continues to refer to the provision as "section 57(a)(8)."

[3] For example, in the years at issue in this case, the minimum tax imposed a special levy on, among other items: (i) the excess of a taxpayer's "accelerated" depreciation on real property, over the amount that would be allowed under straight-line depreciation, 26 U.S.C. § 57(a)(2); (ii) the otherwise tax-deferred economic benefit received by an employee on receiving stock pursuant to certain employee stock options, 26 U.S.C. § 57(a)(6); (iii) the portion of a taxpayer's capital gain income otherwise shielded from tax, 26 U.S.C. § 57(a)(9); and (iv) the extent to which rapid amortization deductions allowed, under the regular tax rules, for child care facilities exceeded regularly allowable depreciation, 26 U.S.C. § 57(a)(10).

Percentage depletion is a more generous system, which was designed to encourage mineral exploration and production. As this Court noted in *Commissioner v. Engle*, 464 U.S. 206, 209 (1984), "[t]hrough these depletion provisions, Congress has permitted taxpayers to recover the investments they have made in mineral deposits and to generate additional capital for further exploration and production of the Nation's mineral resources." Under percentage depletion, the deduction allowed each year is *not* based, as a general matter, on the cost of the mineral in place. Instead, each year's percentage depletion is computed as a specified percentage of the gross income from the property for that year, subject to various limitations based on the net income realized from the property. 26 U.S.C. §§ 613, 613A. For example, in 1981 and 1982, the years involved in this case, independent oil and gas producers with relatively small volumes of production [4] were allowed percentage depletion at rates ranging from 18 to 22 percent of gross income, depending on the circumstances of production, and the deductions were not to exceed 50 percent of the net income from the property, or 65 percent of the taxpayer's overall taxable income. Despite the limitations placed on percentage depletion allowances, they often exceed the deductions that would be allowable under the cost depletion method. Moreover, because percentage depletion is not computed by reference to the cost of a property, percentage depletion deductions are not limited by that cost and can be taken, as a general matter, so long as production continues.

At particular issue in this case is the manner in which the minimum tax statute, at 26 U.S.C. § 57(a)(8), seeks to "take back" a portion of the percentage depletion allowance. Section 57(a)(8) provides that the items of tax

[4] Other oil and gas producers generally were allowed only cost depletion. Hard minerals producers, like small independent oil and gas producers, generally qualify for percentage depletion. 26 U.S.C. §§ 613-613A.

preference, for purposes of the minimum tax, shall include:

> [w]ith respect to each property (as defined in section 614), the excess of the deduction for depletion allowable under section 611 for the taxable year *over the adjusted basis of the property* at the end of the taxable year (determined without regard to the depletion deduction for the taxable year). (Emphasis supplied.)

The dispute between petitioner and respondent focuses on the meaning of "adjusted basis of the property," as used in section 57(a)(8).

The parties agree that determining the "adjusted basis of the property" requires reference to 26 U.S.C. § 1016. Section 1016(a) provides, in relevant part, that "[p]roper adjustment in respect of the property *shall in all cases be made . . . for expenditures . . . properly chargeable to capital account.*" (Emphasis added.) Section 1016 thus makes clear that the costs of capital expenditures are added to the basis of the property. The original cost basis of the property is adjusted upward for the cost of improvements to the property. The statute governing adjustments to basis dates from the earliest days of the federal income tax,[5] and it provides straightforward support for the taxpayer's position.[6] The courts below properly held that, as defined and used in section 1016, "adjusted basis of the property" includes the unrecovered cost of improvements, both tangible and intangible, to the property. Thus, the courts below held that the adjusted basis of respondents' oil and gas properties should be adjusted for such im-

[5] The provision for adjustments to basis now found at 26 U.S.C. § 1016(a) was first enacted as part of § 202(b) of the Revenue Act of 1924, ch. 234, 43 Stat. 253, 255 (1924): "In computing the amount of gain or loss . . . proper adjustment shall be made for . . . any expenditure properly chargeable to capital account . . . ."

[6] As discussed below, the statute has long been interpreted by Treasury regulations that strongly support the taxpayer's position.

provements as the pipes, pumps and other machinery that have been placed on their properties in order to produce oil and gas.

The government seeks to avoid the result that necessarily flows from this longstanding and coherent approach. It notes that the introductory language in section 57(a)(8)—"with respect to each property (as defined in section 614)"—incorporates the definition of "property" appearing in section 614. (*See* Br. at 15).[7] Section 614, in turn, defines "property" to mean the "mineral deposit."[8] This is obviously correct as far as it goes. The difficulty is that section 57 does not define the preference item by the excess of depletion over the original cost basis of the property, *i.e.*, the original basis of the mineral deposit, but by the excess of depletion over the "adjusted basis" of the property. Both section 1016 and the regulations thereunder, which had long existed when section 57 was enacted,[9] require that basis be adjusted for "improvements" to the property. The government appears to admit, (*see* Br. at 23), that Congress must have legislated against this background. Accordingly, as the Federal Circuit held below, "absent a clear indication in the Code

[7] References throughout this amicus brief to "Br. at ——" are to the government's opening brief in this case.

[8] Br. at 15. The apparent purpose of section 614 is to provide a means for determining where one mineral property ends and another begins. This question can be important, because the calculation of depletion allowances, for purposes of both the regular tax and the minimum tax, depends in part on the extent to which properties are aggregated. *Cf.* 26 U.S.C. § 614(c) (giving taxpayer election whether to aggregate certain mineral properties for purposes of computing depletion); 26 C.F.R. § 1.57-1(h)(1) (1991):

> The determination under section 57(a)(8) is made with respect to each separate property. Thus, for example, if one mineral property has an adjusted basis remaining at the end of the taxable year, such basis may not be used to reduce the amount of an item of tax preference resulting from another mineral property.

[9] See discussion below, p.16-17.

or related regulations to the contrary," the established meaning of "adjusted basis" should apply. (Pet. App. at 11a.)

This Court's precedents make clear that when Congress employs a term that has a commonly understood meaning, it may be presumed to have incorporated that established construction into the statute. In *Cottage Savings Ass'n v. Commissioner*, 111 S.Ct. 1503 (1991), this Court held that in order for an exchange of property to constitute a "disposition of property" resulting in realization of taxable income under section 1001 of the Internal Revenue Code, 26 U.S.C. § 1001(a), the properties exchanged must be "materially different." The Court adopted this construction of the statute because the "contemporary legal context" at the time that Congress enacted section 1001 reflected a similar approach, and the Court presumed that Congress had intended to codify those principles in the statute. 111 S. Ct. at 1507-08.[10] So here Congress enacted section 57(a)(8) against a background in which there was a well understood interpretation of the term "adjusted basis of the property."

Unfazed by this logic, the government urges that the basis of the mineral deposit is not to be adjusted for improvements to the mineral property. (Br. at 21.) This argument is difficult to fathom. The government concedes that "the adjusted basis of a property generally includes 'the costs of improvements and betterments to a property' when these expenditures are 'properly chargeable to the [sic] capital account.'" (Br. at 21.) It also

[10] Similarly, in *Nationwide Mut. Ins. Co. v. Darden*, 112 S.Ct. 1344 (1992), this Court held that the term "employee," used in the Employee Retirement Income Security Act, carried its traditional common-law meaning. The Court wrote that "[w]here Congress uses terms that have accumulated settled meaning . . . a court must infer, unless the statute otherwise dictates, that Congress meant to incorporate the established meaning of those terms." 112 S.Ct. at 1348, *quoting Community for Creative Non-Violence v. Reid*, 490 U.S. 730, 739 (1989).

admits that "the machinery and equipment used in mineral production represent tangible 'improvements' to the mineral deposit." (Br. at 11; *see also* Br. at 23.) Indeed, the government goes so far as to agree that when the mineral property is sold, the adjusted basis for computing gain or loss must include these tangible improvements. (Br. at 24.)

However, the government claims that the regulations in effect before the minimum tax was enacted specifically provided an exception to the general rule—that for depletion purposes the mineral property and the improvements would be placed in separate capital accounts, so that the adjusted basis of the mineral property did not include the improvements.[11] (Br. at 21-23.)

The problem is that no such regulations existed. The regulations upon which the government relies are applicable only to cost-based depletion and not to percentage depletion. The government concedes that the regulation upon which it relies "pertains only to the basis for cost depletion" and that "[t]he regulations covering percentage depletion under Section 613 do not specifically address basis." While the government relegates these concessions to a footnote, (Br. at 18 n.13), in fact, these concessions are highly significant. Where there is no applicable regulation, it is quite impossible to conclude that Congress, without saying so, adopted the special cost

[11] The government's brief in support of this "separate account" theory misquotes the statute. Petitioner mistakenly quotes 26 U.S.C. § 1016(a) as providing for adjustments to basis for expenditures "properly chargeable to *the* capital account." (Br. at 21 (emphasis added).) In fact, section 1016(a)(1) refers to amounts "properly chargeable to capital account," without the "the" that petitioner has inadvertently inserted. Petitioner's slip is symptomatic of the fundamental misunderstanding of "adjusted basis of the property" that underlies petitioner's litigation posture in this case. "Adjusted basis of the property," as used throughout the tax laws, is an aggregate concept, as the Code makes clear. While one property may contain various cost recovery accounts, there remains one property, with one adjusted basis.

depletion rules for the percentage depletion calculations. Indeed, the very congressional directive that percentage depletion be limited to the "adjusted basis" of the mineral property necessarily assumed that the basis would be adjusted by the improvements to the property.

Petitioner's attempt to interpret a property's "adjusted basis" as excluding the cost of tangible improvements is inconsistent not only with the language of section 1016(a), but also with the language used in other provisions of the statute. Perhaps most important is the language of 26 U.S.C. § 611(a):

> *In the case of mines, oil and gas wells, other natural deposits,* and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion *and for depreciation of improvements,* according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary. (Emphasis added.)

Obviously this provision views depreciable improvements as components of the "mines, oil and gas wells, [and] other natural deposits" for which depletion is allowed.

Section 263(a)(1), 26 U.S.C. § 263(a)(1), one of the most central provisions of the Internal Revenue Code, indicates with similar plainness that "improvements" are part of the underlying "property." Section 263(a)(1) is designed to distinguish between those amounts, such as business expenses, that are deductible, and those amounts that are not deductible but instead must be charged to capital account. Section 263(a)(1) provides that deduction shall not be allowed for "[a]ny amount paid out for *new buildings or for permanent improvements or betterments made to increase the value of any property or estate.*" (Emphasis added.)

There is simply no basis for reading the term "adjusted basis" in section 57(a) as having a special and unique meaning that would exclude improvements. When

a word or phrase is employed in different sections of a statute, it "is presumed to have the same meaning in all subsections of the same statute." *Patterson v. Shumate*, 112 S.Ct. 2242, 2447 n.2 (1992) (interpreting phrase "applicable bankruptcy law" so as to achieve uniformity of meaning within bankruptcy code).[12] Any other rule would be a recipe for confusion. Petitioner cannot, in the course of this litigation, insist upon a meaning of "adjusted basis of the property" for purposes of section 57(a)(8) that is different from its meaning in other provisions of the Internal Revenue Code.[13]

Alternatively, the government argues, in essence, that whether or not Congress said so, Congress must have intended to tax the excess of the depletion allowance over the basis of the mineral deposit (excluding improve-

[12] *See also Morrison-Knudsen Constr. Co. v. Director, Office of Workers' Compensation Programs*, 461 U.S. 624, 633 (1983) (term "wages" carries same meaning throughout Longshoremen's and Harbor Workers' Compensation Act); *Mohasco Corp. v. Silver*, 447 U.S. 807, 826 (1980) (rejecting interpretation of Civil Rights Act of 1964 that would give same word two different meanings).

[13] Petitioner looks in vain to the legislative history for significant guidance in this case. (*See* Br. at 25-26.) None of petitioner's references negates the view that "adjusted basis" includes improvements to the property. As the courts below noted in describing their own view of the legislative record:

> At oral argument, [the government] characterized the legislative history of Sections 56 and 57 as "not all that helpful." The court agrees. There are brief statements that arguably benefit each side, but nothing definitive.

(Pet. App. at 15a n.10.) Indeed, as the courts below noted, the conference report to the 1969 Tax Reform Act refers to the " 'cost *or other basis* on which the depletion preference is computed,' " language which suggests, in accordance with the plain language of the statute as enacted and in accordance with petitioner's administrative interpretations, that the basis referred to in section 57(a)(8) is the basis after adjustment pursuant to the regular rules for basis adjustment. *Id., quoting* H.R. Conf. Rep. No. 782, 91st Cong., 1st Sess. (1969), *reprinted in* 1969-3 C.B. 644, 659 (emphasis the courts').

ments). In other words, if the property originally cost $1 million, and $2 million in improvements had been added, the tax preference should be in the amount by which depletion deductions exceeded $1 million rather than the amount it exceeded $3 million. This is fair, says the government, because depreciation attributable to the improvements is separately deductible. (Br. at 16-17.)

The difficulty with this argument is that it assumes rather than establishes the congressional purpose. The mere fact that Congress sought to impose a minimum tax and did not intend to permit a taxpayer to pay " 'a shockingly lower percentage of his income as tax,' " (Br. at 13), hardly establishes that Congress sought to impose the minimum tax on all the total amount of benefits from percentage depletion. Yet that is exactly what the government would do. If Congress had intended to do so, it would have been simple enough to craft the appropriate language. Congress did not, however, take this step.

Nor does the minimum tax as a whole reflect a congressional design to invariably impose a tax on all "unfair" benefits created by other sections of the Code, as the government suggests. (Br. at 28-29.) There is no inherent "logic" to that tax scheme. As one commentator has noted:

> Analysis of the alternative tax demonstrates that it is ill-conceived in every respect. The results reached by application of the alternative tax provisions are either inherently inequitable or involve unduly circuitous and cumbersome calculations.[14]

The essentially imprecise approach reflected in the minimum tax is perhaps best illustrated, for current purposes, by the preference for intangible drilling costs contained in the current version of the minimum tax. 26 U.S.C.

[14] Glenn E. Coven, *The Alternative Minimum Tax: Proving Again That Two Wrongs Do Not Make A Right*, 68 Calif. L. Rev. 1093, 1094 (1980).

§ 57(a)(2) (1988 & Supp. 1992).[15] This provision shows plainly the attempt by Congress to achieve an essentially arbitrary balance between the interests of avoiding what was perceived as excessive use of favorable tax provisions,

[15] 26 U.S.C. § 57(a)(2) defines the preference as follows:

(2) Intangible drilling costs.—

(A) In general.—With respect to all oil, gas, and geothermal properties of the taxpayer, the amount (if any) by which the amount of the excess intangible drilling costs arising in the taxable year is greater than 65 percent of the net income of the taxpayer from oil, gas, and geothermal properties for the taxable year.

(B) Excess intangible drilling costs.— For purposes of subparagraph (A), the amount of the excess intangible drilling costs arising in the taxable year is the excess of—

(i) the intangible drilling and development costs paid or incurred in connection with oil, gas, and geothermal wells (other than costs incurred in drilling a nonproductive well) allowable under section 263(c) or 291(b) for the taxable year, over

(ii) the amount which would have been allowable for the taxable year if such costs had been capitalized and straight line recovery of intangibles (as defined in subsection (b)) had been used with respect to such costs.

(C) Net income from oil, gas, and geothermal properties.— For purposes of subparagraph (A), the amount of the net income of the taxpayer from oil, gas, and geothermal properties for the taxable year is the excess of—

(i) the aggregate amount of gross income (within the meaning of section 613(a)) from all oil, gas, and geothermal properties of the taxpayer received or accrued by the taxpayer during the taxable year, over

(ii) the amount of any deductions allocable to such properties reduced by the excess described in subparagraph (B) for such taxable year.

(D) Paragraph applied separately with respect to geothermal properties and oil and gas properties.—This paragraph shall be applied separately with respect to—

(i) all oil and gas properties which are not described in clause (ii), and

(ii) all properties which are geothermal deposits (as defined in section 613(e)(2)).

and of retaining some incentive for particular economic activities. The deduction of intangible drilling costs is treated as a "preference" because such expenses normally would be capitalized and amortized over the life of the mine. Under the government's theory of the purpose of the minimum tax, such amounts should be treated as preferences in full. However, Congress has chosen a more limited approach, treating these benefits as subject to the minimum tax only to the extent they exceed 65 percent of the taxpayer's net income from oil, gas and geothermal properties. Thus, Congress, in the "intangible drilling cost" preference, has sought to achieve a balance between the desirability of encouraging mineral development, on the one hand, and the desire to curtail tax benefits, on the other. Precisely the same kind of balance is involved here.

Nor is there anything inherently illogical about such an approach. The government itself concedes that Congress has long favored certain oil and gas and mineral producers. (Br. at 3.) As the court below noted, Congress, in the preference for percentage depletion as well as in the preference for intangible drilling costs, apparently wished to preserve some of the tax benefits under the minimum tax and thus to encourage mineral development. This case turns on the clear language of the statute, not on petitioner's perception of the "logic" underlying the minimum tax.

II. EVEN IF THE STATUTE WERE AMBIGUOUS, THE TREASURY'S OWN REGULATIONS INTERPRETING THE STATUTE ARE A REASONABLE INTERPRETATION AND ARE ENTITLED TO DEFERENCE.

Even if the statute were not plain on its face, the Treasury's own regulations make clear that the adjusted basis of a mineral deposit includes the tangible improvements to the property.

This Court has "long recognized that considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer. . . ." *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844 (1984). The weight accorded administrative interpretations has, if anything, been especially great in the highly technical and specialized area of taxation.[16] A government agency, as much as a private party, is bound to follow the agency's administrative interpretations.[17]

And the regulations here are quite clear. Petitioner's specific regulations under Section 57 of the minimum tax provide: "For the determination of the adjusted basis of the property at the end of the taxable year *see section 1016 and the regulations thereunder.*" 26 C.F.R. § 1.57-1(h)(3) (emphasis added). This is the regulation that petitioner has issued specifically to define "adjusted basis of the property" for purposes of section 57(a)(8). It appears in a portion of the regulations devoted specifically to the minimum tax, which is the portion of the tax laws at issue in this case. It is the *only* regulation that petitioner has issued in order to define that term for purposes of section 57(a)(8). And this regulation sets forth the definition plainly and unequivocally. "Adjusted basis of the property," for purposes of section 57(a)(8), is adjusted as provided in section 1016 and the regulations thereunder.

[16] *See, e.g., Commissioner v. South Texas Lumber Co.*, 333 U.S. 496 (1948); *National Muffler Dealers Ass'n, Inc. v. United States*, 440 U.S. 472 (1979).

[17] *See Fort Stewart Schools v. Federal Labor Relations Authority*, 495 U.S. 641, 654 (1990) ("It is a familiar rule of administrative law that an agency must abide by its own regulations"); *Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939) (applying this principle to an attempt by the Commissioner to disavow a tax regulation).

Petitioner's regulations under section 1016 provide:

> The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, *including the cost of improvements and betterments made to the property.*

26 C.F.R. § 1.1016-2(a) (emphasis added).[18]

Petitioner seeks to avoid the obvious consequences of its own regulations by suggesting that, in the case of mineral property, the regulations do not mean what they say. Petitioner's primary support for this view of its own regulations is that *another* section includes a special definition of "adjusted basis" that excludes tangible improvements.[19] As we have discussed earlier, and as the

[18] The language of today's 26 C.F.R. § 1.1016-2(a) apparently originated in the House Ways and Means Committee report accompanying the 1924 Revenue Act:

> [T]he cost or other basis of the property . . . shall be increased by the amount of items properly chargeable to capital account and decreased by depreciation and similar deductions allowed with respect to the property. Under this provision capital charges, *such as improvements and betterments* . . . are to be added to the cost of the property . . . .

H.R. Rep. No. 179, 68th Cong., 1st Sess. 1924), *reprinted in* 1939-1 (Part 2) C.B. 241, 250; see generally 2 Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 42.1 at 42-2 (2d ed. 1990). This regulation has been in effect at least since 1932. *See* United States Dep't of the Treasury, *Regulations Relating to the Income Tax Under the Revenue Act of 1922*, art. 605 (1933). The longstanding nature of this interpretation entitles it to particular weight. *Pauley v. Bethenergy Mines, Inc.*, 111 S. Ct. 2524, 2535 (1991).

[19] Petitioner also seeks to find some support for its position in the fact that the depletion regulations, at one point, contain a definition of "mineral enterprise," which is distinguished from "mineral deposit." (Br. at 22.) The very limited use of the term "mineral enterprise" in petitioner's regulations has nothing whatever to do with this case. The term "mineral enterprise" is used five times in petitioner's tax regulations. The first time it appears, in 26 C.F.R. § 1.611-1(d)(3), the term is simply defined. It also appears in 26 C.F.R. § 1.611-1(d)(4), dealing with the apportion-

government concedes, (Br. at 18 n.13), the regulations under section 612 deal only with *cost* depletion. 26 C.F.R. § 1.612-1(b)(1). Petitioner did *not* create a special definition of this kind in section 1.57-1(h)(3), the one regulation governing the depletion preference under the minimum tax. Nor have the regulations under section 57 adopted the adjusted basis provisions in the section 612 regulations. Instead, petitioner has provided explicitly in that provision that the Code's regular definition, of 26 U.S.C. § 1016 and the regulations thereunder, shall apply.[20]

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ment of cost on the acquisition of a mineral interest; 26 C.F.R. § 1.611-2(e), dealing with the valuation of mineral properties by reefrence to the operating record of the mineral enterprise; 26 C.F.R. § 1.612-1(c), which is simply a cross-reference to the definitions of section 1.611-1(d)(3); and 26 C.F.R. § 1.613-4(i), dealing with extraction from waste or residue. It is difficult to see how the use of this phrase in these peripheral regulations detracts anything from the meaning of 26 C.F.R. § 1.57-1(h)(3), which petitioner promulgated precisely to address the statutory provision at issue in this case.

Petitioner also seeks to gain comfort from regulations that, for various purposes of tax accounting, require a taxpayer to maintain more than one cost recovery account for a single property. (*See* Br. at 22 and n:15, *citing* 26 C.F.R. §§ 1.611-2(b)(1), 1.611-5(c), and 1.167(a)-7.) For example, the different buildings in an apartment complex might have been constructed at different times, under different legal regimes, and be subject to depreciation at different rates. Similarly, as the current case demonstrates, some elements of a mineral property may be depletable, some may be depreciable, and some amortizable as deferred development expenses. The maintenance of these separate accounts within the same property does not derogate from the unity of the property, as 26 U.S.C. § 611(a), quoted at p. 11, illustrates.

[20] The very fact that under section 612 petitioner apparently perceived a need to specify that it was departing from the general rule, and to specify in section 1.612-1(b) that adjusted basis does *not* include depreciable amounts for purposes of cost depletion, suggests that in the absence of specification to the contrary, adjusted basis *does* include such amounts.

Petitioner in its brief not only ignores the relevant regulations[21] but also ignores Technical Advice Memorandum ("TAM") 8314011, a private ruling that petitioner issued in 1982 and which strongly supports the taxpayer's position. Tech. Adv. Mem. 8314011 (Dec. 22, 1982). TAM 8314011 involved the question whether certain "deferred development expenditures" should be included in a property's "adjusted basis" for purposes of the same minimum tax provision involved in this case. Like the costs of depreciable tangible improvements, deferred development expenditures are amortized not by depletion but by a separate capital recovery scheme. *See* 26 U.S.C. § 616. Indeed, deferred development expenditures generally include costs of depreciable tangible property used in developing a property.[22] Thus, deferred development expenses include the costs of tangible improvements, and are indistinguishable from the costs of tangible improvements involved here.

In TAM 8314011, the IRS determined, in language equally applicable to this case, that deferred development expenses should be included in "adjusted basis of the property" for purposes of section 57(a)(8). The IRS said:

> The term "adjusted basis" has the same meaning whether used in section 57(a)(8), section 612, or elsewhere in the Code except where the term is specifically defined differently. Section 1.57-1(h)(3) of the regulations dealing with the definition of adjusted basis uses section 1016 and the regulations thereunder. *There is no separate authority for determin-*

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[21] It is noteworthy that petitioner's brief cites a great many tax regulations, (Br. at v-vi), but does not once cite 26 C.F.R. § 1.57-1(h)(3), the regulation that is most directly applicable to the question in this case.

[22] *See* 26 U.S.C. § 616(a) (final sentence); 26 C.F.R. § 1.616-1(b)(2). The costs added to basis under this provision are limited to the amounts attributable to depreciation during the development period.

> *ing an "adjusted basis" for purposes of the minimum tax, and another for determining gain or loss on the sales of property.*

(Emphasis added.) *Cf. Patterson v. Shumate*, 112 S. Ct. 2242 (1992). Such TAMs are entitled to consideration by the courts under *Chevron*, even though by statute they are not conclusive on the agency.[23] The approach taken in the TAM is completely inconsistent with the government's litigation position in this case.

Petitioner's regulation (section 1.57-1(h)(3)) and its technical advice memorandum plainly demonstrate acceptance of the principle that the adjusted basis of a property includes the unrecovered cost of improvements to the property. It is only today, long after the promulgation of 26 C.F.R. § 1.57-1(h)(3) and TAM 8314011, that petitioner seeks to apply a special definition of adjusted basis. Petitioner should not now be permitted to disavow this interpretation.

In the past this Court has repeatedly declined to permit the government to reject its previous interpretation of the tax laws. In *Hanover Bank v. Commissioner*, 369 U.S. 672 (1962), the Commissioner suddenly found fault with a longstanding administrative interpretation that permitted bondholders to assume, for purposes of amortizing and deducting premiums paid on the acquisition of bonds, that the bonds would be redeemed at the "special call price," which typically is lower than the price at which bonds actually are redeemed. The Commissioner's interpretation thus allowed taxpayers to claim deductions that were, quite clearly, greater than required to compensate them for their economic costs, but the Commissioner belatedly sought to repudiate the prior administrative position. This Court rejected the Commissioner's attempt because "[t]he regulations in effect [as of the tax year at issue] give no support to the Government's present contention" and because the government had previously rejected it. 369 U.S. at 686-87. Here, as in *Hanover Bank*, petitioner's regulations give no hint of the position that petitioner now asserts, and the Treasury should not be permitted to disavow its earlier view.

[23] *Hanover Bank v. Commissioner*, 369 U.S. 672, 686 (1962) (Court states that private rulings, while not constituting formal precent, "reveal the interpretaiton put upon the statute by the agency charged with the responsibility of administering the revenue laws"); *accord, Rowan Cos., Inc. v. United States*, 452 U.S. 247, 261 n.17 (1981).

Petitioner cannot, of course, claim that its litigation position put forth in this case is, in itself, an "interpretation" entitled to deference. This Court has explicitly rejected deference to such ad hoc "interpretations." *See Bowen v. Georgetown University Hospital*, 488 U.S. 204, 212 (1988); *Cottage Savings Ass'n v. Commissioner*, 111 S.Ct. 1503, 1509 (1991). In *Bowen*, the Secretary of Health and Human Services abandoned a past interpretation of a Medicare reimbursement provision, offering a different interpretation for the first time in his appellate brief. 488 U.S. at 212-13. This Court refused to pay "[d]eference to what appears to be nothing more than an agency's litigating position," noting that the Court had "never applied the [*Chevron*] principle . . . to agency litigating positions that are wholly unsupported by regulations, rulings or administrative practice." 488 U.S. at 213, 212. *See also Cottage Savings Ass'n v. Commissioner*, 111 S.Ct. at 1509 (deference is warranted only to "an authoritative, prelitigation interpretation").

CONCLUSION

For the foregoing reasons the decision of the Court of Appeals should be affirmed.

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